

Federal Update 2004-23

July 28, 2004

TO: NCTR Membership

FROM: Cindie Moore, Washington Counsel

RE: Recent Pension and Social Security Developments

Hi Everyone. Congress left Washington last week to begin its August recess. They will reconvene September 7. This report will recap several developments during the past few weeks in Congress and elsewhere. It will cover the following issues:

- Recap on MDR Final Regulation
- House Committee Passes Social Security Number Bill
- Other Social Security Developments: WEP Legislation and Social Security Administration Guidance on Section 419 Notice
- Proposed Changes to Nonqualified Deferred Compensation Plans Threaten to Ensnare Governmental Section 415(m) Plans
- Pending Pension Proposals: 1) Administration's Pension Package; and 2) Portman-Cardin/NESTEG Legislation
- Comparison of Governmental Provisions in S. 2424, National Employee Savings Trust Equity Guarantee Act (NESTEG) with those in H.R. 1776, the Portman-Cardin Bill

Note that any references to Federal Updates may be found at [www.nctr.org](http://www.nctr.org) under the Federal Developments icon.

### **Recap on MDR Final Regulation**

The most significant development over the past weeks has come not from Congress, but IRS and the Department of the Treasury. They released on June 14 the final regulation on the minimum distribution rules (MDRs) for defined benefit plans and other retirement vehicles. The MDRs, located in Section 401(a)(9) of the Internal Revenue Code, specify how and when payments from various retirement programs must be made.

The final regulation applies to COLAs, benefit distribution options, and other features of state and local government plans. Wayne Schneider, General Counsel for the New York State Teachers' Retirement System, and I provided a summary of how the final regulation will affect state and local government plans, located at Federal Update 2004-20. I also posted the final regulation at Federal Update 2004-19. If you have not yet reviewed these materials, I recommend you do so.

Keep in mind these key points on the final regulation:

➤ Grandfathering for Governmental Plans: Any annuity distribution option provided under the terms of a governmental defined benefit plan in effect as of April 17, 2002 will satisfy Section 401(a)(9), provided “the distribution option satisfies [Section 401(a)(9)] based on a reasonable and good faith interpretation of the provisions of [Section 401(a)(9)].” The final regulation does not give a definition of “reasonable and good faith interpretation.” However, it is likely a broad standard that would permit most types of options.

➤ Changes Made after April 17, 2002: You must follow the final regulation. Note two scenarios:

-If you made a change on or after April 17, 2002 and before June 15, 2004, the final regulation provides an opportunity to make change. See our memo for more detail.

-If you make a change on or after June 15, 2004, you must make it in conformance with the final regulations.

➤ General Reaction to Final Regulation; Problems for Future; Solution: IRS incorporated into the final regulation most of the concerns expressed by NCTR members. The final regulation provides for a wider range of permissible indices for COLAs. It also allows a flat percentage increase of not greater than five percent. It liberalizes the restrictions in the IRS’ temporary regulations and proposed regulations on a joint and survivor annuity with a younger non-spouse beneficiary. These changes, along with the grandfathering, make the final regulation workable for most NCTR members **for the present**. The **future** is a **different story**. **Problems** with the final regulation will likely arise in two areas. First, to what extent will future changes in the existing distribution options negate the grandfather? Second, in the event a state or local government wishes to make major changes in distribution options, those options must precisely follow the final regulation, even if it would create a more restrictive design than desired by the state or local government. A **solution** appears in the key House and Senate pension bills (H.R. 1776 and S. 2424). Each bill has a provision that allows governmental plans to be deemed as having complied with Section 401(a)(9) if they follow a reasonable good faith interpretation. NCTR intends to lobby to retain this important provision in the final version of any pension bill. For more information about the provision, see Portman-Cardin/NESTEG legislation, below.

### **House Committee Passes Social Security Number Bill**

The House Ways and Means Committee approved on July 21, H.R. 2971, which would restrict both governments and private firms from selling and publicly displaying Social Security numbers. Rep. Clay Shaw (R-FL), who sponsored the bill, has worked on this legislation for several years.

As relates to state and local government retirement systems, the bill would, among other things, prohibit federal, state, and local governments from 1) selling SSNs (limited exceptions would be made to facilitate law enforcement and national security, to ensure the accuracy of credit and insurance underwriting information, for tax purposes, and to the extent authorized by the Social Security Act); and 2) displaying SSNs to the general public.

NCTR members should note several other proposed changes. The following practices would be banned:

- Displaying SSNs on checks issued for payment and accompanying documents.
- Displaying SSNs on identification cards and tags issued to employees or their families.
- Requiring the transmission of SSNs over the Internet without encryption or other security measures.

In addition, both the public and private sectors would be required to safeguard SSNs they have in their possession from unauthorized access by employees or others. The sale, purchase, or display of SSNs in the public or private sector would be permitted by the U.S. Attorney General in other circumstances, when appropriate. In making this determination, the Attorney General would consider the costs and burdens to the public, government, and businesses. If the sale, purchase, or display were to be authorized, the Attorney General would provide for restrictions to prevent identity theft, fraud, deception, crime, and risk of bodily, emotional, or financial harm.

The bill would create new criminal (up to 5 years imprisonment and fine up to \$250,000) and civil (up to \$5,000 per incident) penalties for violations of the law relating to the display, sale, purchase, or misuse of the SSN. It would enhance prison sentences for SSN misuse associated with repeat offenders (up to 10 years), drug trafficking or crimes of violence (up to 20 years), or terrorism (up to 25 years).

The bill now moves to two other House committees for consideration: 1) Financial Services, and 2) Energy and Commerce. Similar legislation, S. 228, is pending in the Senate. Because the two House Committees have yet to consider the bill and a narrow window of time exists before adjournment, the chance for passage this year is not great.

In a related development, President Bush signed into law (Public Law 108-528) an identity theft bill on July 15. The bill adds two years to prison sentences for those convicted of using stolen credit card numbers and other personal data to commit crimes.

### **Other Social Security Developments: WEP Legislation and Social Security Administration Guidance on Section 419 Notice**

#### WEP Legislation

Representatives of employee groups testified at a July 20 hearing in favor of a bill that would eliminate the Windfall Elimination Provision (WEP) and replace it with a new calculation. Rep. Kevin Brady (R-TX) introduced the bill, H.R. 4391, the Public Servant Retirement Protection Act (PSRPA).

The WEP affects an individual who has 1) a pension from non-Social Security covered work and 2) a Social Security benefit from a separate job. The Social Security Administration (SSA) calculates the benefit of such an individual under a modified formula, known as the WEP. The WEP reduces such individual's benefit unless he/she has between 20 and 30 years of substantial Social Security earnings, in which case the decrease is less. If the individual has 30 or more years of substantial Social Security earnings, the WEP is inapplicable. In no event does the WEP reduce an individual's Social Security benefit by more than 50 percent.

H.R. 4391 would end the WEP and adopt in its place a calculation based on an individual's actual earnings during his/her years of work. Specifically, the PSRPA calculation treats the individual's non-Social Security covered earnings as if they were covered by Social Security and applies the standard benefit formula. To ensure the individual's Social Security benefit is based only on the Social Security covered earnings (as opposed to earnings from the non-Social Security covered work), the benefit would be multiplied by the percent of earnings covered by Social Security. In order to carry out the calculation, the worker's earnings from all work, both Social Security and non-Social Security covered must be known. In addition to establishing a new calculation, the bill eliminates the substantial years of Social Security coverage exception and ends the 50 percent floor protection.

The employee representatives said that H.R. 4391 was a good first step toward repeal of the WEP and the government pension offset (GPO), which reduces or eliminates the spouse and survivor benefits for most retirees who collect a pension from a non-Social Security covered job. The representatives spoke on behalf of such organizations such as the National Education Association and the Fraternal Order of Police. A representative from the Social Security Administration noted, however, that H.R. 4391 would cost \$7 billion over 10 years, a costly amount during a time of large budget deficits. Thus, prospects for passage are not good.

#### Social Security Administration (SSA) Guidance on Section 419 Notice

As I've previously reported, the Social Security Protection Act of 2004 includes a new notice requirement for state and local government employers when hiring an individual into a non-Social Security covered position. It requires such an employer to provide the individual with a notice explaining the effect of non-coverage on any separate Social Security covered work by the individual. In other words, the benefit from the Social Security covered work might be reduced because of 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. The requirement is effective for individuals who begin non-Social Security covered jobs on or after January 1, 2005.

The Act requires the Social Security Administration (SSA) to draft the notice. SSA officials scheduled a meeting with state and local government representatives earlier this month. Before the meeting took place, however, they postponed it to sometime in August or September. Once the meeting does occur, I will provide an idea of what SSA is proposing for the notice.

## **Proposed Changes to Nonqualified Deferred Compensation Plans Threaten to Ensnare Governmental Section 415(m) Plans**

Provisions in corporate and international tax reform legislation passed by the House and Senate would substantially change the rules applicable to nonqualified deferred compensation plans (H.R. 4520, the “American Jobs Creation Act of 2004”; S. 1637, the “Jumpstart Our Business Strength Act”). In general, the provisions would tax immediately amounts deferred (including earnings) under a nonqualified deferred compensation plan unless certain requirements were satisfied. The proposed legislation targets primarily voluntary salary and bonus deferrals by executives of for-profit corporations, but apparently would also apply to Section 415(m) plans. Such plans have acquired a variety of names, such as excess benefit, spill-overs, slivers, and tag-alongs. Their sole purpose is to provide participants with the portion of their annual benefit otherwise payable under the terms of the defined benefit plan that exceeds the Section 415(b) dollar limits. Typically, benefits under Section 415(m) plans are paid at the same time and in the same form as the employee elects under the underlying qualified plan when the employee retires.

Assuming the legislation applies to Section 415(m) plans, problems identified include:

- Initial elections regarding the timing and form of payments under Section 415(m) plans would be required at the time the participant begins service under the plan – which often would be decades before retirement and before the participant even knows whether he/she will be covered by a Section 415(m) plan.
- Because of the limitations on “subsequent elections,” it appears that payments pursuant to an election made at retirement would have to be delayed for at least five years – well after retirement has begun.
- As a result, it appears that benefits under a Section 415(m) plan would be taxed immediately because the benefits under it are typically paid at the same time and form that the participant elects pursuant to the underlying defined benefit plan.

Public pension representatives are seeking clarification from congressional tax staff about the application of the provision to Section 415(m) plans. Negotiations are ongoing to complete action on the two bills with the problematic provision.

### **Pending Pension Proposals: 1) Administration’s Pension Package; and 2) NESTEG/Portman-Cardin**

Earlier this year Congress struggled and finally succeeded in crafting a temporary solution for private plan funding. That effort may have dampened their enthusiasm for any further work on pension issues this year. Little action has taken place on two sets of pension proposals pending before Congress.

#### Administration’s Pension Package

The first set of proposals is the Administration’s pension package. It includes Lifetime Savings Accounts (LSAs), Retirement Savings Accounts (RSAs), and Employer Retirement Savings

Accounts (ERSAs). Both LSAs and RSAs establish accounts into which individuals could save up to \$5,000 per year in after-tax funds. Earnings on funds would be tax-free similar to Roth IRAs. Under an LSA, an individual could withdraw savings at any time and for any purpose as opposed to an RSA from which an individual could make withdrawals only after age 58. The ERSA would consolidate 401(k)s, 403(b)s, 457s, and other savings vehicles into a single new plan. Legislation to create LSAs (H.R. 4078 and S. 2263) and RSAs (H.R. 4714; no Senate bill yet) has been introduced, but no action has been scheduled. The ERSA legislation has not yet been introduced.

#### Portman-Cardin/NESTEG Legislation

The second set of proposals is H.R. 1776 by Reps. Rob Portman (R-OH) and Ben Cardin (D-MD) and S. 2424, National Employee Savings Trust Equity Guarantee Act (NESTEG), by Sen. Charles Grassley (R-IA). Both bills have helpful provisions for state and local government plans. A grid comparing S. 2424 to H.R. 1776 appears below.

Reps. Portman and Cardin may introduce a fresh pension bill before adjournment. The bill would include the government plan provisions below, private plan items, and a proposal similar to the Administration's RSA idea (but Reps. Portman and Cardin would not include the LSA and ERSA provisions). When their current bill, H.R. 1776, passed the Ways and Means Committee in 2003, it was caught up in partisan crossfire, even though the bill itself enjoys bipartisan support. A new bill would allow Reps. Portman and Cardin to disassociate their legislation from the partisan rancor and start afresh.

**Comparison of Governmental Plan Provisions in S. 2424, National Employee Savings Trust Equity Guarantee Act (NESTEG) with those in H.R. 1776, the Portman-Cardin Bill**

<b>Provision</b>	<b>NESTEG (S. 2424)</b>	<b>Portman-Cardin (H.R. 1776)</b>
Clarification of Purchase of Service Credit Provisions	<p>#1-Clarifies that purchases of service credit (PSC) for periods for which there is no performance of service is allowable.</p> <p>#2-Clarifies that PSC may include service credited in order to provide an increased benefit for service credit which participant is receiving under plan, i.e., benefit to which participant not otherwise entitled.</p> <p>#3-Clarifies that trustee-to-trustee transfer of 403(b) and 457 funds into governmental defined benefit plan for purchase of PSC is not subject to limits applicable to air time (i.e., not more than 5 years of non-qualified PSC and participant must have 5 years of participation in plan).</p> <p>#4-Clarifies that once 403(b)/457 funds are transferred to governmental defined benefit plan, they take on distribution rules of such plan.</p> <p>#5-Clarifies that transfer need not be made between plans maintained by same employer.</p>	Similar to NESTEG, except that #1 is not included
After-Tax Contributions to Enhance Portability	Allows defined benefit plans to accept after-tax rollovers, if they so wished, provided that they separately track the after-tax funds from the pre-tax funds. At present, defined contribution and other plans may accept these types of rollovers.	Not Included
Relief from Minimum Distribution Rules (MDR) to Ensure Special Features of State and Local Government (SLG) Plans Recognized	Allows SLG retirement plans to be deemed as having complied with MDR of Section 401(a)(9) if they follow a reasonable good faith interpretation. See discussion above about release of Final MDR Regulation.	Same provision
Relief for Public Safety Employees from 10% Early Withdrawal Tax	Exempts 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. Under current law, the age is 55. Provision recognizes that public safety employees often retire earlier than workers in other professions. Thus, they should be permitted to receive distributions from defined benefit pension plans without the imposition of the 10% tax.	Similar, although would define in federal law what a deferred retirement option plan is.

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