CONTENTS

INTRODUCTION

'his pamphlet,[1] prepared by the staff of the Joint Committee on xation, provides a discussion of the issues and legislative propos- relating to the portability of pension plan benefits.

'he Subcommittee on Oversight of the House Committee on ys and Means has scheduled a hearing on July 12, 1988, which l focus on the components of pension benefit losses due to em- yment mobility and current proposals to limit such losses.

'art I of the pamphlet is an overview. Part II provides a descrip- n of present law. Part III describes current legislative proposals ating to pension portability, and Part IV is an analysis of relat- issues.

'his pamphlet may be cited as follows: Joint Committee on Taxation, *Proposals and Issues ting to the Portability of Pension Plan Benefits* (JCS-11-88), July 11, 1988.

I. OVERVIEW

here is no precise definition of portability of pension benefits, the term is often used to refer to a broad range of concepts. In eral terms, portability refers to the ability to maintain pension efits following a change in employment. Individuals who work several employers may have lower pension benefits than indiıals who work for only one employer for a variety of reasons, example, because the individual did not work for any employer ; enough to be vested, because a new employer does not mainı as generous a plan as a prior employer, or because service for prior employer does not count as service under the new em-/er's plan. An individual may also lose pension benefits upon a change because the individual spends a distribution of his or accumulated pension benefit rather than saving the benefit for rement. Pension portability proposals are designed to amelio- the effects of employment changes on pension benefits.

ı order to evaluate any pension portability proposal, it is helpto understand what is meant by portability, and what aspect of :ability any particular proposal means to address. The most-dis-;ed concepts of portability generally fall into three categories: ɔortability of benefits, (2) portability of service (also sometimes ed portability of credited service or portability of service histoand (3) portability of assets (also sometimes called portability of ·ent or present value).

tability of benefits

ortability of benefits generally refers to vesting. Vesting deteres what portion of the individual's benefits the individual has a ıt to. If an individual is vested in some or all of his or her benethen the individual has a right to those benefits. If the individis not fully or partially vested, then all benefits earned up to time of termination of employment are forfeited.

ortability of benefits has also been used to refer to coverage , whether an individual is covered under a retirement plan) and ·erences between retirement plans. These issues often arise in ussions of portability because an individual who is covered by a rement plan will be worse off if he or she changes jobs and the employer does not have a plan or has a plan that does not pro- as high a level of benefits. Coverage and comparability of ben-; are really broader issues, however; an individual may remain he same job throughout his or her working life and never earn ·nsion because the employer does not maintain a plan, or may earn an adequate pension because of the design of the plan. se problems may be inherent in a voluntary private pension em.

Portability of service

Portability of service refers to the ability to count years of s
ice under a plan of a prior employer in determining the pens
benefits under a plan of a new employer. If service is totally po
ble, then all prior service under any plan is taken into acco
both in determining whether an individual is vested and
amount of the individual's benefits.

Portability of service is particularly important in the case of
fined benefit plans. A defined benefit plan is a plan that pays be
fits in accordance with a benefit formula specified in the plan
contrast, a defined contribution plan does not promise a particu
level of benefits; the benefit is the participant's account balance.

A common type of defined benefit plan is a final average
plan. A typical benefit formula for a final average pay plan is,
example, 1 percent x years of service x the average compensat
for the most recent 5 years of service. Some plans will base aver
compensation on the highest years of compensation, for exam
the 5 years in the last 10 years in which the individual's compen
tion was the highest. If service is not portable, then the indiv
ual's benefits from a prior employer are based on compensation
the time of termination, rather than on the higher compensat
that the individual will typically have in later years. Thus, the
dividual will have lower benefits if he or she works for several
ployers than the individual would have if he or she worked
same number of years for one employer.

Except for vesting, portability of service is not as great an iss
in the case of defined contribution plans, because length of serv
typically is not as important in determining benefits. Howev
length of service is used to determine benefits in some types of
fined contribution plans. Portability of service is more important
such cases. In addition, the effects of lack of portability are also
as great in the case of career average defined benefit plans. Su
plans generally base benefits on compensation over the employe
working life, so that future pay increases do not have as great
effect on the overall level of benefits. Even in such cases, the lack
portability of service can cause the employee to lose valuable ea
retirement subsidies or similar benefits.

Portability of assets

Portability of assets refers to the ability to obtain a cash distrib
tion of accumulated benefits and maintain those benefits in a
other retirement arrangement. Discussions of portability of asse
also sometimes involves issues of preservation of benefits followi
a distribution. That is, whether the individual saves the benefit f
retirement or uses the benefit for preretirement purposes.

Recent proposals on portability focus on portability of assets. T
proposals seek to increase portability of assets by increasing t
ability to keep pension benefits in a tax-favored retirement vehic
such as an IRA, following termination of employment, for examp
by requiring transfer to an IRA or another qualified plan, or e
panding situations in which rollovers or transfers are permitte

ıe proposals also seek to increase the likelihood that pension efits will be saved for retirement by restricting preretirement ibutions. Some also address the broader issue of coverage, pri-ly by modifying the rules relating to simplified employee pen-; (SEPs), particularly the rules relating to the availability of ·y reduction SEPs.

II. PRESENT LAW

Under present law, the pension system that provides the gre degree of portability is the social security system. The social se ty system provides almost universal coverage for all workers, benefits are based on all covered employment. Outside the s security system (i.e., in the private pension system), present la quires portability of service in limited circumstances. There a number of provisions in present law which facilitate portabili assets, the most significant being the ability to roll over dist tions to an IRA. In addition, the withdrawal restrictions appli to tax-qualified retirement plans, as well as the rules regar taxation of benefits, are generally designed to provide incentiv individuals to save pension benefits for retirement purposes, not spend them for preretirement uses.

A. Portability of Benefits

1. Social Security

In general

Social security, covering 93 percent of the Nation's workforce currently the most portable pension system in the United Sta Under social security, covered workers earn benefits at each and benefits are based on the worker's lifetime earnings. T many of the problems sought to be addressed by portable pen proposals are addressed by the social security system.

In general, social security pays benefits to covered emplo who have worked a required period. Benefits may also be pay to a covered worker's spouse and dependents.

In order to be covered under social security, an individual r receive wages and work in covered employment. Wages paid respect to covered employment form the basis for determining amount of benefits payable, and also are the base for determi the taxes used to fund social security benefits. Such taxes are under the Federal Insurance Contributions Act (FICA). FICA poses both an employee-level tax, which is withheld from wage ments, and an employer-level tax, which matches the employee

Self-employed persons are also generally covered by social sec ty. Self-employed persons are not subject to the employee or

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[2] Committee on Ways and Means, U.S. House of Representatives, *Background Materia Data on Programs within the Jurisdiction of the Committee on Ways and Means 1988 E* (March 24, 1988) p. 3.

[3] This discussion is limited to benefits provided under the Old-Age and Survivors Insu (OASI) program. Related benefits are also provided under the Disability Insurance (DI) pro and the Hospital Insurance (HI or Medicare) program. For a more complete discussion of benefits, see Committee on Ways and Means, U.S. House of Representatives, *Background rial and Data on Programs within the Jurisdiction of the Committee on Ways and Means Edition* (March 24, 1988).

yer portion of the FICA tax, but instead are subject to taxes ler the Self-Employment Contributions Act (SECA). The SECA is currently less than the total employee and employer FICA es, but will be comparable beginning in 1990.

ered employment

Iearly all employment is covered employment under social secu-, with some exceptions. Federal Government employees hired oré January 1, 1984, are not covered by social security. State l local government units elect whether or not to join the social urity system. Certain other miscellaneous types of service are excluded from the definition of covered employment, for exam-, service performed by a child under the age of 18 for a parent, vice by an individual covered by the railroad retirement system, l certain domestic service performed by certain relatives.[4]

he trend in recent years has been to expand the definition of ered employment and, therefore, the classes of employees cov-d by social security. For example, coverage of Federal Govern-nt employees is required for employees hired after December 31, 3. State and local governments that elect to be covered under ial security could, prior to 1983, elect to terminate coverage. h withdrawal from the social security system is no longer per-ted. Employees of religious, charitable, educational, and certain er tax-exempt organizations used to be covered by social securi-nly if the organization filed a notice with the Internal Revenue vice agreeing to such coverage. Beginning in 1984, all employees ax-exempt employers are covered by social security.

ered wages

n general, the definition of wages for social security purposes in-des all remuneration for employment below the social security ge base (including the cash value of remuneration not paid in form of cash). For 1988, the taxable wage base is $45,000. There a number of exceptions to this all-inclusive rule. For example, ments to or from a qualified plan and certain disability pay-nts are not considered wages for social security purposes.[5]

s with the definition of covered employment, the trend has n to expand the definition of wages, thus expanding coverage, well as the funding base for social security benefits. For exam-, generally effective for remuneration paid after December 31, 3, elective deferrals under a qualified cash or deferred arrange-nt (i.e., a sec. 401(k) plan) are considered wages. Similarly, the nibus Reconciliation Act of 1987 expanded the definition of ges in a number of ways, such as by including cash tips as ges.

ting

n general, entitlement to social security benefits is based on rters of coverage. The maximum number of quarters required benefits is 40. The number of required quarters may be less, de-ding on the particular benefit and the age of the individual.

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[4] For a complete list of excluded service, see sec. 3121(b).
[5] For a complete list of excluded items, see sec. 3121(a).

The 40-quarter requirement is being phased in over time, and il be fully phased in for individuals who reach 62 in 1991 or la

The requirement of 40 quarters of coverage to earn a benefit (e. 10 years of service) is longer than that currently required un most private sector retirement plans, and longer than the vesting schedules that will go into effect in 1989 under the Reform Act of 1986 (see discussion below). Nonetheless, it is m easier for an individual to accumulate the required service un social security because all covered employment with any emplo is taken into account. Thus, the problem that exists under priv pension plans, that an employee may switch jobs without becom vested and lose credit for prior service, is not as prevalent in social security system. Nearly all employees with significant w history are able to accumulate a benefit under social security.

2. Overview of Qualified Plans, SEPs

Under a plan of deferred compensation that meets the qualifi tion standards of the Internal Revenue Code (a qualified plan), employer is allowed a deduction for contributions (within limits a trust to provide employee benefits. Similar rules apply to pl funded with annuity contracts. A qualified plan may be a pensi profit-sharing, or stock bonus plan.

An employer's deductions and an employee's benefits unde qualified plan may be limited by reference to the employee's co pensation. The Code also imposes overall limits on benefits or c tributions that may be provided under qualified plans.

Under a qualified plan, employees do not include benefits gross income until the benefits are distributed even though plan is funded and the benefits are nonforfeitable. Tax deferra provided under qualified plans from the time contributions made until the time benefits are received. The employer is entit to a current deduction (within limits) for contributions to a qu fied plan even though an employee's income inclusion is deferr

In addition, employees may make after-tax contributions to qualified plan and defer taxation on the earnings on such contri tions until distribution from the plan. An employee may also ma elective deferrals to a qualified plan on a salary reduction bas Elective deferrals are excludable from gross income when ma and are not taxed until distributed from the plan.

Benefits or contributions under a qualified plan are subject standards designed to prohibit discrimination in favor of high compensated employees. In addition, qualified plans are required meet minimum standards relating to coverage (what employe participate in the plan), vesting (the time at which an employe benefit becomes nonforfeitable), and benefit accrual (the rate which an employee earns a benefit). Also, minimum funding stan ards apply to the rate at which employer contributions are quired to be made under certain types of plans to ensure the s vency of pension plans.

A simplified employee pension (SEP) is another type of tax- vored retirement arrangement. Under a SEP, the employer contr utes directly to an IRA established for the employee. A contrib tion must be made for an employee for a year if the employee is

;t age 21, has performed service during at least 3 of the immedi-
ly preceding 5 years, and received at least $300 of compensation n the employer for the year. Contributions must bear a uniform ıtionship to compensation. Under the Tax Reform Act of 1986, ployers with less than 25 employees may establish SEPs on a ıry reduction basis. Like qualified plans, contributions to SEPs excludable from income and earnings accumulate on a tax-de-·ed basis.

3. Vesting Under Qualified Plans

jeneral

Inder the Tax Reform Act of 1986, for plan years starting after 8, a qualified plan must satisfy one of two faster vesting sched-
;. One permissible vesting schedule is 5-year cliff vesting, under ch participants are fully vested after 5 years of service, but are required to be vested before then. Alternatively, a plan may vide a graduated vesting schedule beginning with 20 percent ting after 3 years of service and increasing to 100 percent after ears of service. A plan may provide for faster vesting than the uired minimum.

rior to the effective date of the Tax Reform Act vesting rules, ployer contributions under qualified plans are generally re-
red to vest under one of three schedules. The three permissible edules are (1) 10-year cliff vesting, which requires that a plan ticipant be vested upon completion of 10 years of service, but re-
res no vesting prior to that time; (2) 5-to-15-year vesting, which vides for graduated vesting between 5 and 15 years of service, t is, a participant is partially vested after 5 years of service and percentage of vesting increases each year until the participant ully vested after 15 years of service; and (3) rule-of-45 vesting, ch provides graduated vesting depending on the participant's and years of service. Under rule-of-45 vesting, it may take as ; as 15 years for a plan participant to become fully vested.

ltiemployer plans

he Tax Reform Act vesting rules do not apply to multiemployer ıs. A multiemployer plan is a plan to which more than one em-
/er contributes pursuant to collective bargaining agreements. ltiemployer plans typically operate on an industry-wide basis. ltiemployer plans must provide for vesting at least as rapid as ear cliff vesting.

nder a multiemployer plan, participants generally earn credit service with any employer that contributes to the plan. It is ıetimes argued that longer vesting schedules are appropriate for ltiemployer plans because this feature allows a participant to tinue to earn service after switching jobs and, thus, allows par-
pants who change employment to become vested in situations re they would not become vested if they participated in a plan ntained by a single employer.

-heavy plans

special vesting schedule applies to top-heavy plans. In general ns, a top-heavy plan is a plan in which a high percentage of the benefits are provided to "key employees." Key employees incl certain owners and officers of the employer and certain hig compensated individuals. A top-heavy plan must provide eithe year cliff vesting or graduated vesting between 2 and 6 year service (20 percent per year of service).

Employee contributions, salary reduction contributions

Employee contributions and salary reduction contributions t qualified cash or deferred arrangement (i.e., a sec. 401(k) plan) required to be fully vested and nonforfeitable at all times.

4. Coverage

Other than social security, present law does not require an ployer to provide retirement benefits for its employees. Present provides tax benefits with respect to qualified plans with the int that these benefits will be sufficient incentive for employers to tablish retirement plans. If an employer does establish a quali plan, then present law imposes coverage and nondiscrimination quirements that are designed to ensure that the plan benefits ra and-file employees as well as highly compensated employees.

Under present law, a plan is not qualified unless the plan sa fies at least one of the following coverage requirements: (1) plan benefits at least 70 percent of all nonhighly compensated e ployees (the "percentage test"), (2) the plan benefits a percentage nonhighly compensated employees that is at least 70 percent of percentage of highly compensated employees benefiting under plan (the "ratio test"), or (3) the plan meets the average bene test. A plan meets the average benefits test if (1) the plan bene such employees as qualify under a classification set up by the e ployer and found by the Secretary not to be discriminatory in fa of highly compensated employees, and (2) the average benefit p centage for nonhighly compensated employees of the employer is least 70 percent of the average benefit percentage for highly co pensated employees of the employer.

In addition, a plan generally cannot require as a condition participation that an employee complete a period of service exte ing beyond the later of (1) the date on which the employee attai age 21, or (2) the date on which the employee completes 1 year service.

As noted above, a separate coverage rule applies to SEPs. Und a SEP, a contribution must be made for an employee for a year the employee is at least age 21, has performed service during least 3 of the immediately preceding 5 years, and received at lea $300 of the compensation from the employer for the year.

B. Portability of Service

Present law does not generally require portability of servic That is, when an individual changes employers, service with t old employer generally is not required to be taken into account determining benefits under the new employer's plan.

Present law does provide for some portability of service in t case of related employers. For this purpose, related employers i clude corporations under common control, trades or business ether or not incorporated) under common control, and certain iated service groups. Control is generally defined as 80 percent ership.

or purposes of the minimum vesting requirements, service with related employers is taken into account. For example, if an individual working for one company is transferred to a related company then service with the first company is generally required to be en into account in determining whether the individual is vested er the plan of the new employer.

n the other hand, service with related companies is not re-ed to be taken into account in determining years of participa- for purposes of calculating an employee's benefit. Thus, if an loyee transfers to a related company that maintains a different than his or her original employer, the benefits under the new need only be based on service with the new employer. Al-igh tacking of service is not required in such cases, as a matter ractice, some employers will take into account all service with nbers of the controlled group.

resent law also provides that, in the case of an employer that ntains a plan of a predecessor employer, service for the predeor is treated as service for the employer. In addition, in the of an employer maintaining a plan which is not the plan ntained by a predecessor employer, service with the predecessor eated as service for the employer to the extent required by regions.

he predecessor employer rule could result in some portability of ice in a number of situations, particularly in the case of corpo- mergers and acquisitions and similar transactions. However, e are as yet no regulations defining predecessor employer or erwise interpreting the provision, so that the scope of the provi- is unclear.

ultiemployer plans often provide portability of service. Such is typically provide that an employee earns benefits as long as employee works for any participating employer. Thus, employ-can change jobs among participating employers without inter-ting benefit accrual. Such portability is not mandated by law, ever, and the extent to which service with participating em-ers is taken into acccount may differ from plan to plan.

C. Portability of Assets

1. In General

here are a number of provisions in present law that facilitate ability of assets. Present law encourages portability by permit- assets to be rolled over or to be transferred from one tax-fa-ed retirement arrangement to another, and by providing incen-s to individuals to save amounts received from retirement plans retirement purposes.

2. IRA Rollovers and Transfers

n individual may generally roll over a distribution received n a qualified plan to an IRA if (1) the distribution is a total dis-ution of the individual's entire interest in the plan, or (2) the distribution is a qualified partial distribution of the individual's terest in the plan. To the extent a distribution is rolled over an IRA, it is not includible in income and is not subject to the percent additional income tax on early distributions (see below) course, when such amounts are subsequently distributed from IRA, they are includible in income and subject to the 10-percent ditional income tax unless an exception to the tax applies.

A total distribution may be rolled over to an IRA if it is made because of the death of the individual, (2) after the individual attained age 59½, (3) because of termination of employment (ot than in the case of a self-employed person), or (4) in the case of s employed persons only, after the individual becomes permaner disabled. In the case of these distributions, a distribution is a to distribution only if it includes the individual's complete share all of the employer's pension plans, or profit-sharing plans, or st bonus plans. That is, for this purpose, all plans of the same t are treated as a single plan. A total distribution may also be rol over if it is made because of a termination of a plan. In order qualify as a partial distribution, a distribution must be at least percent of the individual's interest in the plan and meet cert other requirements.

Only employer contributions (and income on employer or empl ee contributions) may be rolled over to an IRA. Distributions of e ployee contributions cannot be rolled over.

Tax-free rollovers and transfers between IRAs are permitted, though certain restrictions may apply.

3. Rollovers and Transfers to Another Qualified Plan

Distributions from qualified retirement plans can generally rolled over to another qualified plan or transferred to anoth qualified plan on the same basis that distributions can be rol over to an IRA, except that partial distributions may only be rol over to an IRA. Present law does not require that plans perr transfers or rollovers from another qualified plan. Plan provisio permitting such transactions are likely to be most prevalent in t case of related companies or where there has been a merger or quisition.

4. Incentives to Retain Funds for Retirement Purposes

Withdrawal rules

In some cases, present law restricts the ability of employees obtain a distribution from a qualified retirement plan prior to te mination of employment. In the case of pension plans, i.e., defin benefit plans and money purchase pension plans, distributio cannot be made prior to termination of employment. Elective co tributions to qualified cash or deferred arrangements (sec. 401(plans) cannot be distributed prior to termination of employmer attainment of age 59½, death, disability, or financial hardshi Contributions to profit-sharing and stock bonus plans generally ca be distributed within 2 years of when they were contributed. Em ployee contributions generally may be withdrawn at any time.

lan could impose stricter restrictions on plan distributions than ıose imposed by law.

The qualification rules generally require that a distribution be vailable upon the attainment of normal retirement age. Whether n employee who terminates employment prior to normal retire-ıent age has the right to obtain a current distribution of the value f his or her benefit depends on the terms of the plan. Defined con-ibution plans generally permit a distribution of the employee's ccount balance upon termination of employment. In defined bene-t plans, there are not separate accounts for each individual and, s a result, distributions often are not available until retirement ge. Some employers prefer not to make lump-sum distributions vailable from their defined benefit plans, because doing so can ffect the funded status of the plan.

If the present value of the employee's benefit does not exceed 3,500, the benefit may be distributed upon termination of employ-ıent to the individual without the individual's consent. Many lans, including both defined contribution plans and defined bene-t plans, will cash out benefits of less than $3,500 because the em-loyer will want to avoid the administrative burdens of keeping ·ack of small benefits for former employees.

If the present value of the individual's benefit exceeds $3,500, ıen the benefit cannot be distributed prior to the later of normal etirement age or age 62, unless the participant consents to the dis-ibution. Thus, participants with larger benefits have the option of eferring a plan distribution until retirement age. Leaving the ben-fits in the plan may be more beneficial than obtaining a distribu-on. For example, it would make it more likely that the individual ould not spend the benefit prior to retirement. In addition, the ıte of return under the plan may be greater than the rate of eturn available outside the plan.

axation of distributions

A number of rules regarding taxation of distributions are de-gned to encourage individuals to save distributions for retirement urposes rather than use them for current consumption. For exam-le, the Tax Reform Act of 1986 added a 10-percent additional ıcome tax on all early distributions from qualified retirement ans, including IRAs. Prior to the Reform Act, a similar 10-per-ent tax applied to early distribution from IRAs and early distribu-ons to certain "key employees," such as 5-percent owners, from a ıalified plan.

The tax is an additional income tax, so it only applies to the por-on of a distribution includible in income. Thus, the tax does not pply to distributions of employee contributions or to the portion of distribution that is rolled over to another qualified plan or an A.

In addition, the additional tax does not apply to distributions (1) ter attainment of age 59½; (2) due to the death of the individual;) due to the disability of the individual; (4) used to pay medical penses that would be deductible if the individual itemized deduc-ons (not applicable to IRAs); (5) that are part of a series of sub-antially equal periodic payments made for the life or life expect-ıcy of the individual (or the joint lives or joint life expectancies of

the individual and his or her spouse); (6) made in the case of a
employee who separated from service after attainment of age 5
(not applicable to IRAs); (7) from an employee stock ownersh
plan; or (8) made pursuant to a qualified domestic relations ord
(not applicable to IRAs).

Other changes in the Tax Reform Act were also designed t
reduce the incentive to take distributions prior to retiremen
Under the law prior to the Tax Reform Act, an individual who r
ceived a lump-sum distribution could elect to apply 10-year incon
averaging to the distribution, which treated the distribution as if
had been received over a 10-year period. In addition, under pric
law, the portion of a lump-sum distribution attributable to contr
butions prior to January 1, 1974, could qualify for treatment a
long-term capital gains.

The Tax Reform Act phased out long-term capital gain treatmer
over 6 years and replaced 10-year forward averaging with 5-yea
forward averaging. In addition, 5-year income averaging may b
elected only after the individual has attained age 59½, and onl
one such election may be made.

In making these changes, Congress determined that the prior-la
averaging provisions encouraged individuals to withdraw tax-fa
vored funds from tax-favored retirement arrangements before re
tirement and were therefore inconsistent with the policy of provic
ing income at retirement. The original purpose of the provision
was to mitigate the effects of the progressive income tax structur
on individuals receiving all of their benefits in a single year. Th
same purpose is now served, however, by permitting individual
generally to roll over distributions into an IRA.

The Tax Reform Act also changed the rules relating to the trea
ment of basis (e.g., employee contributions) when an individual re
ceives a distribution from a tax-favored retirement arrangement t
which both employee and employer contributions have been made
Under prior law, if an amount was received before the annuit
starting date (i.e., the date on which an amount was first receive
as an annuity), the individual was treated as first receiving the ir
dividual's own investment in the contract (basis), which was nor
taxable, and then taxable income. The 1986 Tax Reform Act mod
fied the basis recovery rules for pre-annuity starting date distribu
tions to provide for the pro-rata recovery of basis. Thus, with re
spect to such a distribution, an individual is entitled to exclude a
amount determined by multiplying the amount of the payment b
the ratio of the individual's basis to the total value of the accrue
benefit under the plan.

In making this change, Congress determined that the prior-lav
rule permitted the accelerated tax-free recovery of employee contr
butions and thus further encouraged the use of tax-favored retire
ment arrangements for nonretirement purposes.

III. DESCRIPTION OF LEGISLATIVE PROPOSALS

A. Pension Portability Act of 1988

ɪ.R. 1961[6]—Mr. Jeffords, Mr. Hawkins, Mrs. Roukema, and Mr. Clay)

Explanation of Provisions

general

H.R. 1961, as reported by the House Committee on Education d Labor, would modify the rules relating to distributions from alified plans (sec. 401(a)), qualified annuity plans (sec. 403(a)), ɛ-sheltered annuity contracts (sec. 403(b)), and individual retire- ənt arrangements (IRAs) (sec. 408). Generally, the bill would pro- le that (1) in certain circumstances, direct transfers to IRAs are ɿuired in lieu of distributions; (2) the Secretary of the Treasury ıy permit the distribution of employee contributions to be rolled ər; (3) distributions from IRAs must be made with the consent of ə IRA owner; (4) certain spousal rights to survivor benefits are ɿuired for IRAs and tax-sheltered annuity contracts; (5) certain ntax provisions are made applicable to pension plans consisting one or more IRAs; and (6) the rules relating to salary reduction ;Ps are modified.

ansfers

[n general, the bill would require that single-sum distributions to ıployees or their spouses from qualified plans, qualified annuity ıns, and tax-sheltered annuity contracts (qualified retirement ıns) be made in the form of a direct trustee-to-trustee transfer to IRA. This requirement would not apply, however, if (1) the əsent value of the employee's accrued benefit exceeds $3,500; (2) lifferent form of benefit is elected; and (3) commencement of pay- ·nt of the benefit is not deferred. This requirement also generally uld not apply to governmental plans, church plans, certain zen plans, and certain plans to which employers do not contrib- ə.

[he bill also would require that an individual be permitted to nsfer IRA assets to another IRA or to a qualified retirement ın that accepts such transfers.

ɪ.R. 1961 was referred jointly to the House Committees on Education and Labor and Ways Means, and was reported, with amendments, by the Committee on Education and Labor on ə 7, 1988 (H. Rpt. 100-676, Part 1). S 2343 (introduced by Senator Quayle) is the same as H.R. as reported.

Rollovers

Under the bill, the Secretary may permit distributions fro qualified retirement plans of employee contributions to be roll over to another such plan or to an IRA.

IRA distributions

Under the bill, certain assets in IRAs may not be distribut without consent of the IRA owner. The assets subject to this ru are assets transferred from a qualified retirement plan and asse in a SEP. An exception would be provided for distributions in tl form of a 50-percent qualified joint and survivor annuity or single life annuity to the extent that such distributions are r quired by the minimum distribution rules.

Spousal rights

Present law provides an individual with certain rights to surv vor benefits with respect to his or her spouse's interest in qualifi plan assets. The bill would extend these rights to IRAs and ta sheltered annuity contracts by treating such arrangements as no pension defined contribution plans. However, with respect to IRA such treatment would only apply to assets transferred from a qua fied retirement plan and assets in a SEP.

IRA pension plans

The bill would provide that pension plans consisting of one more IRAs are subject to certain requirements under Title 1 ERISA. Generally, IRA pension plans are to be treated as oth pension plans under Title 1, except that the funding rules do n apply and only certain rules under Part 2 (generally relating participating and vesting) apply. In general, the rules applicab under Part 2 are (1) the participation rules (with special rules fo SEPs); (2) the prohibition on alienation or assignment; and (3) th vesting rules (with the modification that all interests must be 10 percent vested).

Salary reduction SEPs

Under certain circumstances, the bill would allow employers establish a new type of SEP that permits employees to reduce the salary and contribute the amount of such reduction to the SE This alternative arrangement would be available to employe (other than State or local governments or tax-exempt organiz tions) not otherwise maintaining a qualified plan or qualified ann ity plan. Under the bill, such salary reduction SEPs would be su ject to nondiscrimination rules that are similar to, but less restri tive than, the rules applicable under present law to salary redu tion SEPs. The bill also would modify certain other nondiscrimin tion requirements for all SEPs, without regard to whether the allow salary reduction.

Effective Date

The bill would be effective for plan years and taxable years be ginning after December 31, 1991.

B. Portable Pension Plan Act of 1987

I.R. 1992 [7]—Mr. Feighan, Mr. Matsui, Mr. MacKay, Mr. Bates, Mr. Dymally, Mr. Towns, Mr. Rangel, Mr. Berman, Mr. Chandler, Mrs. Byron, Mr. Savage, Mr. Morrison, Mr. Murphy, Ms. Kaptur, Mr. Evans, Mr. Gray, Mr. Fauntroy, Mr. Wolpe, and Mr. Crockett)

Explanation Provisions

general

In general, H.R. 1992 would provide that (1) the 10-percent early stribution tax (Code sec. 72(t)) is raised to 20 percent; (2) the exptions to the early distribution tax are modified; (3) the distribun rules for qualified plans, SEPs, and eligible deferred compensan plans are modified to reduce the amount of preretirement disbutions; (4) employers that do not maintain qualified plans must tablish a salary reduction SEP on request by an employee; (5) lary reduction SEPs may be maintained by any employer; (6) lary reduction SEPs established by an employer must be availle to all of the employer's employees, but no other nondiscrimation rules apply to such SEPs; (7) integration is impermissible SEPs; (8) SEPs are subject to Title 1 of ERISA (with certain spel provisions); (9) the Secretary of Labor is to help small employs in establishing plans; and (10) the Comptroller General is to dy pension plan administration and portability.

rly distribution tax

The bill would modify the early distribution tax in several rects. First, it would raise the tax from 10 percent to 20 percent. cond, it would extend the exception for medical hardship to As. Third, the bill would exempt from the tax distributions from erminated defined benefit plan subject to Title IV of ERISA. The l also would modify the exceptions for distributions after (1) age ½, (2) early retirement after age 55, and (3) death. Under the , such exceptions would not apply unless the distributions are made with spousal consent, or (2) made in a series of substanlly equal periodic payments over the life or life expectancy of participant or of the participant and his or her beneficiary. rther, the bill would eliminate the substantially equal periodic ment exception as an independent exception.

tributions

Under the bill, qualified plans may not make an immediate disution of any assets unless the distribution satisfies one of two

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I.R. 1992 was referred jointly to the House Committees on Education and Labor and Ways Means.

requirements: (1) the distribution is one that is exempt from th early distribution tax, or (2) the distribution is a transfer to a por ability maintenance plan. A portability maintenance plan is d fined as a qualified plan, SEP, or IRA, provided that the SEP IRA is subject to the bill's distribution rules.

In addition, the bill would provide that if a participant separat from service prior to retirement and his or her vested employ benefit exceeds $3,500, the participant may require the plan transfer his or her benefit to a portability maintenance plan. Th plan may make such a transfer with respect to lesser benefits.

These distribution rules also would apply to SEPs and eligible d ferred compensation plans (sec. 457). However, the rules would n apply to distributions of dividends for which the employer takes deduction under section 404(k).

Salary reduction SEPs

Under the bill, any employer may maintain a salary reductio SEP. In addition, employers that have not maintained a qualifie plan, qualified annuity plan, or tax-sheltered annuity contract f the past 5 years must establish a salary reduction SEP if requeste to do so by any employee. The bill also exempts salary reductio SEPs from (1) all nondiscrimination rules other than the requir ment that all employees be eligible to make salary reduction co tributions, and (2) the limits on employer contributions. The bi further prohibits SEPs from using integration to satisfy the nondi crimination rules applicable to contributions other than salary r duction contributions.

Title 1 of ERISA

The bill would provide that SEPs are pension plans for purpose of Title 1 of ERISA. However, SEPs would be subject to certain sp cial rules: (1) the Secretary of Labor is to prescribe simplified rul for reporting and disclosure; (2) SEP assets must be 100 percen vested; (3) the applicable participation requirements are those im posed by the tax Code; and (4) there are no minimum fundin rules.

Secretary of Labor

The Secretary of Labor would be required to take appropria action, including dissemination of information, to facilitate th adoption of qualified plans by small employers. The Secretary is t report annually on his or her efforts, together with appropriate le islative recommendations.

Comptroller General

The Comptroller General would be required to conduct a study qualified plan administration and portability and report the resul of the study to Congress within a year of the date of enactmen

Effective Date

The bill generally would be effective for plan years beginning on r after January 1, 1988, with a delayed effective date for collecively bargained plans and a delayed date for plan amendments. 'he requirements with respect to the Secretary of Labor's efforts egarding small employers would be effective on enactment.

C. Other Proposal

(H.R. 2643 [8]—Mr. Chandler)

Explanation of Provisions

In general

In general, H.R. 2643 would provide that (1) defined contributio plans must accept rollover contributions; (2) qualified plans ma not make distributions with respect to an employee before the en ployee has attained age 59½ (with an exception); (3) qualified pla distributions must be made over the life of the employee or le rapidly (with certain exceptions); (4) an employee who separat from service may require that his or her qualified plan benefit b transferred to another plan or IRA; (5) IRA assets attributable t transfers from qualified plans are subject to the rules of (2) and (above; and (6) the rules for salary reduction SEPs are modified i certain respects.

For purposes of the above rules, qualified annuity plans ar treated like qualified plans.

Distribution rules

The bill would prohibit qualified plans from making distribution with respect to an employee before the employee attains age 59½ The bill also would require that distributions from a qualified pla be made over the life of the employee or less rapidly. These rule would not apply to those covered under the early retirement prov sions of the Tax Reform Act of 1986. The rules also would no apply to certain distributions that are exempt from the early distr bution tax (sec. 72(t)), direct transfers to another plan or IRA, o amounts used to pay for nursing home care or long-term care in surance. Under the exemption based on section 72(t), the rule would not apply to distributions (1) on or after the death of the em ployee, (2) attributable to the employee's disability, (3) after earl retirement after age 55, (4) to the extent of deductible medical ex penses, (5) from employee stock ownership plans (ESOPs) unde certain circumstances, and (6) under qualified domestic relation orders (sec. 414(p)).

Transfers

Under the bill, a qualified plan must allow an employee who sep arates from service to transfer his or her benefit to another plan o IRA.

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[8] H.R. 2643 would only amend the Internal Revenue Code, and was referred to the Hous Committee on Ways and Means. S. 1349 (introduced by Senator McCain) is identical to H.F 2643.

A distributions

Ƭhe bill would provide that IRA assets attributable to a transfer m a qualified plan are subject to the distribution rules described ɔve.

llover contributions

Jnder the bill, a defined contribution plan must accept rollover ıtributions from the employees of the sponsoring employer, proled that such contributions relate to a distribution from a qualid plan.

lary reduction SEPs

Ƭhe bill would provide that an employer (other than a State or al government or tax-exempt organization) of any size may ıintain a salary reduction SEP if it does not maintain a qualified ın. In addition, the bill would require that an eligible employer ablish a salary reduction SEP if any employee so requests.

Effective Date

Ƭhe bill would be effective for years beginning after 1988, with a ayed effective date for collectively bargained plans.

IV. ISSUES AND ANALYSIS

The major focus of current legislative proposals is portability pension plan assets. The proposals seek to increase portability such assets by increasing the ability to keep pension benefits in tax-favored retirement vehicle, such as an IRA, following termin- tion of employment. Some proposals also increase the likeliho that pension benefits will be saved for retirement purposes by stricting preretirement distributions. Some proposals also addre the broader issue of coverage, primarily by expanding SEPs, pa ticularly the availability of salary reduction SEPs.

A. Portability of Benefits

1. Vesting

The current legislative proposals generally do not deal with po ability of benefits, and generally do not require faster vesting.

The shorter vesting schedules of the Tax Reform Act should in prove the ability of individuals who change jobs to earn a pensio because more employees will have the opportunity to becon vested. However, the effect of the new vesting schedules will al depend on other factors, such as whether or not the individu saves the benefit until retirement or spends it, and the intere rate the individual earns on the benefits, if they are saved.

The Tax Reform Act vesting schedules may have more effect the case of defined benefit plans than in the case of defined contr bution plans. Although the legal requirements for such plans a the same, as a matter of practice, defined contribution plans fr quently have shorter vesting schedules than defined benefit plan

Of course, even with the new vesting schedules, it is still possib that many individuals will not remain long enough at a single j to become fully vested. This will be particularly true for industri with relatively high turnover rates. For this reason, some wou argue that any portability proposal should require that all benefi be 100 percent vested at all times.

Employers might object to an immediate full vesting requir ment. Full vesting could increase pension costs because employe typically use the benefits forfeited by nonvested employees to fur the benefits of other employees. This increase in pension cos could cause employers to reduce the level of benefits provided the future. In addition, employers often use the promise of a pe sion to encourage employees to stay with the company for number of years, and to reward long-service employees. An imm diate vesting requirement could reduce the ability of employers use pension plans for such purposes.

Coverage

A common approach to the coverage issue in various portability ›posals is to expand the use of SEPs, particularly salary reduc- n SEPs. Some argue that it is appropriate to expand SEPs be- ıse they are relatively easy to administer, and therefore are ıre likely to be used by employers who are concerned about ad- nistrative costs and responsibilities. Salary reduction plans are ely to be attractive to employers who do not want to commit to king a certain amount of contributions each year, or who want minimize pension costs.

Some would argue that if there is any expansion of SEPs (or any ıer tax-favored retirement arrangement), it is important not to ax nondiscrimination rules. Present-law rules are designed to ıure that rank-and-file employees, as well as highly compensated ployees, actually benefit from a plan. Any relaxation of these es would mean shifting tax-favored benefits more in favor of hly compensated employees.

Some would argue that encouraging broader use of elective tax- ored retirement plans, such as salary reduction plans, is not as ely to increase the overall level of retirement benefits as non- ctive arrangements. They would argue that the individuals who most likely to want to contribute to a plan on an elective basis, who would contribute the most on an elective basis, are highly ıpensated employees who would save for retirement in any nt. In order to expand coverage for less highly compensated em- yees, who tend to spend more currently rather than save, non- ctive retirement arrangements should be encouraged.

There are other ways within the present-law retirement plan tem to increase coverage. The present-law coverage rules appli- le to qualified plans generally could be modified to require ader coverage.

Ultimately, some lack of coverage may be inherent in the sent voluntary pension system. The present system uses the tax s to provide an incentive for employers to establish retirement ns. Tax benefits are provided with respect to qualified plans h the intent that these benefits will be sufficient incentive for ployers to establish plans. Nondiscrimination rules are designed ensure that if an employer establishes a plan, it covers rank- -file employees as well as highly compensated employees. Sub- to the nondiscrimination rules and other qualification require- ıts, employers, together with employee representatives in the of collectively bargained plans, decide whether to establish a rement plan, what type of plan to establish, and what level of efits to provide.

Such a voluntary system has its limits, as the tax benefits may be sufficient incentive in some cases for employers to maintain plan or an adequate plan. As long as maintaining a voluntary ate pension system is considered an important policy objective, ı some workers will have no or only a small employer-provided rement benefit and will have to rely more heavily on social se- ty and individual savings to provide retirement income.

Concern over the limitations of a voluntary system led to the de- ›pment of a proposed minimum universal pension system

(MUPS) initially advanced by the 1981 President's Commission Pension Policy. The Commission's proposal would have requi employers to contribute 3 percent of compensation to a defined c tribution plan on behalf of each employee over 25 with at least year of service. Contributions would be 100 percent vested.

Those in favor of some type of MUPS argue that it would ens a minimum benefit for all workers and provide a fully funded p able pension. On the other hand, critics argue that if a more pansive mandatory retirement system is desirable, it would more efficient to expand the social security system rather than tablish an entirely new system to supplement social security.

B. Portability of Service

The current portability proposals do not address the issue portability of service. Thus, these proposals may not significan benefit individuals in plans which base benefits on length of se ice, such as defined benefit plans.

Requiring portability of service could be administratively di cult. Records of an employee's service with all employers would required. In addition, pension costs for a new employer could be creased because benefits would be based on service with a prior e ployer. One possible solution to this problem would be to requ as a condition of counting prior service under a new plan, t assets be transferred from the old plan to cover the benefit fr the old plan. The administrative problems that would need to addressed to ensure a fair portability system could be one reas why recent proposals do not address this issue.

C. Portability of Assets

The current legislative proposals focus on increasing the portal ity of assets. Many of the proposals would have that effect, by panding the ability to retain pension funds in tax-favored arran ments following termination of employment and restricting pre tirement withdrawals from tax-favored arrangements. Such prop als are consistent with the policy objective that the funds should used for retirement purposes.

Some have argued that there should be a Federal clearingho for retirement benefits in order to facilitate portability. In the that became ERISA in 1974, the Senate passed a provision est lishing a clearinghouse that would have been administered by t Pension Benefit Guaranty Corporation (PBGC) and would have cepted transfers of lump-sum distributions from qualified pla Such transfers would have been made only if the employer ma taining the plan and the employee agreed to the transfer. The c cept of a clearinghouse was also included as part of the 1981 Pre dent's Commission on Pension Policy MUPS proposals.

Those in favor of a clearinghouse argue that it would ease ministration of a portable pension system by providing a cent administrative agency. Opponents of the idea argue that it wo be costly and unnecessary to establish a new agency for this p pose, or further burden existing agencies.

Some employers and employees may object to further restrictio on preretirement distributions. Employers often like to have desi xibility in order to tailor a plan to the needs and desires of em- ıyees. Employees also may want to be able to obtain funds prior retirement to use for nonretirement purposes or in the case of ancial hardship.

Some of the proposals require that distributions be transferred ectly to an IRA, or that transfer is possible without complying h the spousal consent and distribution rules currently applica- to qualified plans. Such proposals also generally extend the con- it and distribution rules to IRAs. While such an extension pro- ts the rights of the spouse in an IRA, it might be objected to by \ trustees and custodians because it will require additional ad- ıistrative responsibilities.

Some proposals also permit employee contributions to be rolled r or transferred to an IRA. In some cases, the individual may e made significant contributions to the pension plan main- ıed by the employer, and some would argue that rollovers of ployee contributions should be permitted in order to permit in- est to continue to accumulate on a tax deferred basis on what ld be a substantial part of an individual's retirement savings.

One reason for prohibiting rollovers of employee contributions to IRA is that it can create administrative problems for IRA trust- and the Internal Revenue Service. If such contributions are ed over, it is necessary to keep track of such contributions, ch have already been taxed and therefore are not subject to tax in upon distribution, separately from other IRA contributions, ch have not previously been taxed and are taxable upon distri- ion.

ome argue that much of the administrative burdens associated h rollovers of employee contributions have been eliminated due he Tax Reform Act. The Tax Reform Act allows individuals to ke both deductible and nondeductible contributions to IRAs. ıs, under the Tax Reform Act, there is a system in place to dis- guish between previously taxed and previously untaxed IRA con- utions. On the other hand, the Tax Reform Act rules have been effect only since the end of 1986, and therefore the adequacy of ı rules arguably has not yet been fully tested.

nother possible objection to permitting rollovers of employee tributions is that it could tend to favor more highly compensat- ndividuals. The ability to defer taxation by making employee tributions to a qualified plan is more attractive to highly com- sated employees than less well-compensated employees. Prior to Tax Reform Act, there were no significant restrictions, such as discrimination rules, applicable to employee contributions. The Reform Act added nondiscrimination rules effective beginning 987. The lack of nondiscrimination rules prior to 1987 means highly compensated individuals may tend to have made great- employee contributions and that they will benefit more from nitting rollovers of employee contributions. As the nondiscrim- ion rules have been in effect longer, the less highly compensat- ndividuals may benefit more.

Some would argue that the current legislative proposals are b
eficial because they increase portability over the degree of porta
ity available under present law. Others, however, would argue t
the current proposals do not significantly address all the issues
sociated with portability (such as portability of service), and t
broader legislation is necessary to have more complete portabil