Federal Legislative and Regulatory Report
May, 2003

I. Status of Proposed Federal Legislation
On May 14, the House approved the Pension Security Act of 2003 (HR 1000) introduced by Representatives John Boehner (R-Ohio) and Sam Johnson (R-Texas). This bill is almost identical to a bill passed by the House last year. It includes provisions that would reduce the legal issues that restrict certain investment companies from offering financial advice to participants as well as some other protections for participants in 401(k) plans covered by ERISA. Although plans of government sector employers are not directly addressed in this bill, protections offered private sector 401(k) plans may provide some guidance to public employers who wish to offer investment advice to participants.

A companion bill has not been introduced in the Senate that addresses the issues included in the Pension Security Act of 2003. The Senate appears to favor tighter rules on investment advisers and the type of advice financial services companies can provide than those included in the House proposal. This is the third time the House has passed similar bills only to see comparable legislation in the Senate face tremendous challenges.

On April 11, the Pension Preservation and Savings Expansion Act of 2003 (HR 1776) was introduced by Representatives Rob Portman (R-Ohio) and Ben Cardin (D-Maryland). This legislation includes provisions that are of special importance to participants of public sector plans:

- Making permanent the provisions of EGTRRA that are scheduled to sunset.
- Expanding contribution limits and enhancing the Saver’s Credit.
- Allowing transfers of up to $500 from unused amounts held in cafeteria plans and medical savings accounts, to an individual’s retirement account.
- Reforming minimum distribution rules to reflect longer life expectancies of American workers.
- Adding tax incentives for participants who elect lifetime distribution options.
- Clarifying the rules regarding the purchase of permissive service credits with tax-deferred account balances.
- Removing the excise tax penalty for public safety employees who retire before age 55.

The full House is expected to vote on this legislation soon. However, a companion bill has not yet been introduced in the Senate.
II. IRS issues Withholding and Reporting Requirements for 457(b) Plans

The Economic Growth and Tax Relief Reconciliation Act (EGTRRA) made many changes regarding how Section 457(b) governmental plan contributions and distributions are reported for income tax purposes. IRS Notice 2003-20 (located at www.irs.gov/pub/irs-drop/n-03-20.pdf) describes the withholding and reporting requirements applicable after December 31, 2001 for employees participating in 457(b) plans. This does not include special reporting rules that apply to independent contractors who participate in a 457 plan. Notice 2003-20 covers:

- Income tax withholding and reporting of annual deferrals made to an eligible 457 plan of a governmental employer
  
  Federal Income Tax (FIT) on contributions and earnings are not subject to income tax until paid to participants or beneficiaries. Deferrals for the calendar year are reported on participants’ W-2s.

- Withholding for distributions from 457(b) plans

  Distributions from retirement plans, including governmental 457(b) plans, are reported on IRS Form 1099R. The IRS recently revised 1099R instructions for distributions made in 2003. You can find these instructions online at www.irs.gov/pub/irs-pdf/i1099r03.pdf.

  Distributions from governmental 457(b) are subject to the same withholding requirements as qualified plans and 403(b) plans. EGTRRA also mandated that governmental 457 plans are subject to elective withholding rules applicable to qualified plans, 403(b) plans and IRAs for distributions not eligible for rollover to employer-sponsored plans or IRAs.

  - Participants may elect tax withholding, including no withholding, on IRS Form W-4P.
  - When no W-4P is filed, default withholding rules will apply to certain types of distributions.

**Federal Income Tax (FIT) Withholding for Retirement Plan Distributions**

<table>
<thead>
<tr>
<th>Type of distribution</th>
<th>FIT Withholding</th>
<th>Default Withholding</th>
</tr>
</thead>
<tbody>
<tr>
<td>Distributions eligible for rollover and directly rolled over to another retirement plan or IRA</td>
<td>None.</td>
<td>None.</td>
</tr>
<tr>
<td>Distribution eligible for rollover but not directly rolled over to another retirement plan or IRA</td>
<td>Mandatory 20% on distribution amount. Does not apply to IRA or deemed IRA distributions.</td>
<td>Mandatory withholding, but additional amount may be requested on IRS Form W-4P.</td>
</tr>
<tr>
<td>Periodic distributions not eligible for rollover</td>
<td>As elected on W-4P.</td>
<td>Married, 3 exemptions.</td>
</tr>
<tr>
<td>Non-periodic distribution not eligible for rollover</td>
<td>As elected on W-4P.</td>
<td>10%.</td>
</tr>
<tr>
<td>Distributions consisting of amounts eligible for rollover and amounts not eligible for rollover Two 1099Rs will be required, one for the eligible rollover amount and the other for amount not eligible for rollover.</td>
<td>Mandatory 20% on eligible amounts not directly rolled over. As elected on W-4P for amounts not eligible for rollover.</td>
<td>10% for non-periodic payment not eligible for rollover. Married, 3 exemptions for periodic payments not subject to rollover.</td>
</tr>
</tbody>
</table>
IRS Notice 2003-20 also identifies the requirements for FICA taxation of employer contributions and employee deferrals to a governmental 457(b) plan. These taxes only apply to employers that are subject to Social Security and/or Medicare tax.

- Employee deferral contributions are subject to FICA taxes at the time they are contributed to the plan.
- Employer contributions and earnings are subject to FICA taxation in the year they vest and will count against the 457 deferral limit at that time. For this reason, it typically is recommended that employers contribute to a qualified plan so that these amounts are not subject to FICA taxation or applied against the participant’s 457 deferral limits.

Additional information can be found in the following publications available on the IRS website at www.irs.gov/pub

- IRS Publication 15, Circular E. Employer’s Tax Guide
- Publication 15-A Employers Supplemental Tax guide
- Publication 963 Federal-State Reference Guide: Social Security Coverage and FICA Reporting by State and Local Governmental Employers

**IRS Issues Award Program Guidance For Volunteer Firefighters**

Nationwide Retirement Solutions has received a number of inquiries from fire departments interested in providing benefits to their volunteer firefighters. Because volunteer firefighters are not considered employees and do not receive a wage they are not eligible to participate in an employer-sponsored retirement plan that is available to employees.

IRS Revenue Ruling 2003-47 provides guidance using an example of a county fire department’s establishment of a Length of Service Award Plan (LOSAP) to provide its volunteer firefighters with these benefits. It serves as a blueprint for establishing a benefit plan for volunteer firefighters and rescue workers.

State law must authorize the establishment of a LOSAP. This plan must meet the requirements of IRC 457(e)(11)(A)(ii) and 457(e)(11)(B) and (C) that the plan be offered only to unpaid volunteers performing qualified services and the annual aggregate amount of the award for any volunteer, including deemed interest, cannot exceed $3,000. Plans meeting the requirements of this section of the Code are not subject to IRC 457(a) or (f).

In Ruling 2003-47, the example county’s LOSAP covers long-term bona fide volunteers performing firefighting, prevention, rescue squad and other essential services for the fire department. The sample plan design provides that:

- A notational account is established for each participating volunteer, crediting that volunteer periodically with service credits and deemed interest based on a reasonable rate of return.
- Assets in the LOSAP remain the property of the employer and are subject to the employer’s creditors.
If a volunteer stops providing services to the fire department prior to satisfying the plan’s age and service requirements, the service award is forfeited.

A volunteer is eligible to receive benefits after satisfying the plan’s age and service requirements. Plan benefits are distributed in 60 monthly installments.

If a volunteer dies before becoming eligible for benefits, the account balance is paid to his or her beneficiary in a lump sum. If the volunteer dies after payments from the plan have begun, the remaining periodic payments are made to the designated beneficiary.

The IRS concluded that the service award amount under this type of plan design were not:

- Includible in the volunteer's gross income until it was actually paid because the receipt of the award was subject to substantial restrictions.
- Treated as wages for FICA purpose and not subject to FICA taxation.

This ruling is located at: www.irs.gov/pub/irs-drop/rr-03-47.pdf.

**IRS Seeks Recommendations for Guidance Priority List**

IRS recently issued Notice 2003-26 asking for recommendations of issues that should be included in its 2003-2004 Guidance Priority List. The list is used to identify and prioritize the tax issues that should be addressed through regulations, revenue rulings, revenue procedures, notices and other published administrative guidance.

In reviewing recommendations and selecting projects for inclusion on the list, the IRS will consider whether the recommended guidance:

- Is consistent with the Internal Revenue Code and congressional intent.
- Promotes sound tax administration.
- Is easily understood and applied.
- Is enforceable by the IRS on a uniform basis; and reduces controversy or lessens the burden on taxpayers and the Service.

Generally, recommendations will be reviewed for inclusion in each of the next quarter’s update if received by May 15, 2003, August 31, 2003, November 30, 2003, or February 28, 2004, respectively.

*Nationwide associates and the Legislative Task Force actively participate in a number of professional and industry groups that make recommendations to the IRS, Treasury and Congress on matters requiring legislation or guidance such as deemed IRAs, finalization of the 457 proposed regulations, revision of the Employee Voluntary Compliance Resolution System (EPCRS), updating the 403(b) regulations and the 457 audit program.*

**III. Social Security Proposals**

Since the beginning of the year, several bills have been introduced that may affect Social Security coverage and benefits. Previous Nationwide monthly legislative reports have covered the
Government Pension Offset (GPO) and proposed legislation to change the requirements for exemption from the GPO.

Congressional hearings earlier this month before the House subcommittee on Social Security dealt with a number of Social Security issues including:

- Mandatory coverage under Social Security of all state and local governments.
- Establishment of professionally managed voluntary accounts to help alleviate expected funding shortfalls.

**House Resolution 25** (with the Senate concurring) stresses House support for voluntary participation, not mandatory participation of state and local governments in Social Security. This is an important declaration since Congress has tried on previous occasions to require mandatory coverage under Social Security for all state and local governments as a way to alleviate future Social Security financial shortfalls.

House members heard testimony from teacher and uniformed employee groups indicating that mandatory coverage under Social Security for all state and local government employees:

- Would not provide them with comparable retirement and disability benefits they now have under their current retirement systems.
- Would add only two years of additional solvency to the Social Security System.
- Would not relieve current Social Security recipients receiving pensions from retirement systems for non-covered employment from Social Security’s GPO or Windfall Elimination Provision which reduce participant and widow Social Security benefits.

**The Social Security Guarantee Plus Act of 2003**

Representative E. Clay Shaw, Jr. (R-FL) has introduced The Social Security Guarantee Plus Act of 2003 (H. R. 75), intended to reduce some of the financial burdens on the Social Security system whose trust funds are estimated to be depleted by 2042.

Shaw’s bill would not alter or divert funds from the current Social Security system. Instead, his bill would permit:

- Persons 18 years and older to voluntarily establish an individual private account provided they have compensation from wages or self-employment.
- Annual contributions to 4% of compensation up to $1,000.
- Contributions to be deposited into an account funded with a choice of three investment portfolios consisting of 60/40, 65/35 or 70/30 mix of common stocks and high-grade corporate bonds, and managed by certified professional account managers.
- Management fees of 25 basis points or $2.50 for every $1,000 under management. The bond portion would be credited with deemed interest based on annual average market yield.
A worker to receive 5% of the account in a lump sum at retirement. The rest of the account would be converted into a lifetime monthly payment, which would be transferred to Social Security to offset promised security benefits.

The retired worker to receive the higher of the Social Security promised benefit or the benefit in the voluntary account. If the recipient dies before collecting all of the benefit, beneficiaries on the account would receive account benefits tax free. Amounts in this voluntary account would not be subject to federal estate taxes, and could not be transferred for any purpose except to pay benefits.

Other provisions of Clay’s bill would:

- Increase payments to widows.
- Phase out the earnings test for Social Security recipients who retire at age 62 instead age 65 and would allow recipients to work without reducing their Social Security benefits.
- Reduce the GPO from 2/3 to 50% of the amount due a surviving spouse from Social Security. The GPO reduction is of interest to surviving spouses who collect a pension from a public retirement system that is not covered under Social Security and who are entitled to benefits as a surviving spouse of a Social Security recipient.

This bill may be found at [www.thomas.loc.gov](http://www.thomas.loc.gov). Enter H.R. 75 (bill number) in the designated box.

**Senate Bill 767**

Senators Evan Bayh (D-IN) and Gordon Smith (R-CA) introduced Senate Bill 767 (S. 767), which would repeal the current rate of income taxation on payments to Social Security recipients whose annual income exceeds certain income levels. The following table illustrates income levels with both the current taxation rate on Social Security payments and the proposed rate.

<table>
<thead>
<tr>
<th>Federal Income Tax Filing Status</th>
<th>Income Level</th>
<th>Proposed Rate of Taxation on Social Security payments</th>
<th>Current Rate of Taxation on Social Security payments (Effective since 1993)</th>
</tr>
</thead>
<tbody>
<tr>
<td>Joint Filer</td>
<td>Above $44,000</td>
<td>50% on amounts in excess of income threshold.</td>
<td>85% on amounts in excess of income threshold.</td>
</tr>
<tr>
<td>Single Filer</td>
<td>Above $34,000</td>
<td>50% on amounts in excess of income level.</td>
<td>85% on amounts in excess of income level.</td>
</tr>
</tbody>
</table>

Supporters of this bill testified before the subcommittee on Social Security that:

- Working encourages all Social Security recipients to be productive members of society and helps boost economic growth.
- Tax penalties prevent many from working.
- Approximately one quarter of all Social Security recipients are now subject to taxes on their Social Security benefit.

This bill may be found at [www.thomas.loc.gov](http://www.thomas.loc.gov). Enter S.767 (bill number) in the designated box.