DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 1776, THE "PENSION PRESERVATION AND SAVINGS EXPANSION ACT OF 2003"

Scheduled for Markup
By the
COMMITTEE ON WAYS AND MEANS
on July 18, 2003

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INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of H.R. 1776, the "Pension Preservation and Savings Expansion Act of 2003" for July 18, 2003. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's amendment in the nature of a substitute to the "Pension Preservation and Savings Expansion Act of 2003."

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 1776, the "Pension Preservation and Savings Expansion Act of 2003"* (JCX-69-03), July 18, 2003.

I. BUILDING AND PRESERVING RETIREMENT ASSETS AND ENHANCING PORTABILITY

A. Acceleration of Scheduled Increases in Pension Plan Contribution Limits

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001[2] ("EGTRRA") increased the contribution limits applicable to employer-sponsored retirement plans.

The annual dollar limit on elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)), a tax-sheltered annuity (sec. 403(b)), or a salary reduction simplified employee pension ("SEP") is $12,000 in 2003, $13,000 in 2004, $14,000 in 2004, and $15,000 in 2006, with indexing for inflation thereafter. The maximum annual elective deferrals that may be made to a SIMPLE plan (secs. 401(k)(11) and 408(p)) is $8,000 in 2003, $9,000 in 2004, and $10,000 in 2005, with indexing for inflation thereafter.

The annual dollar limit on deferrals under an eligible deferred compensation plan of a tax-exempt or State or local government employer (sec. 457) is $12,000 in 2003, $13,000 in 2004, $14,000 in 2004, and $15,000 in 2006, with indexing for inflation thereafter.

Under EGTRRA, individuals who have attained age 50 may make additional catch-up contributions to qualified cash or deferred arrangements, tax-sheltered annuities, salary reduction SEPs, and governmental section 457 plans of up to $2,000 in 2003, $3,000 in 2004, $4,000 in 2004, and $5,000 in 2006, with indexing thereafter. Individuals who have attained age 50 may make additional catch-up contributions to a SIMPLE plan of up to $1,000 in 2003, $1,500 in 2004, $2,000 in 2004, and $2,500 in 2006, with indexing for inflation thereafter.

Description of Proposal

The proposal accelerates the EGTRRA increases in the annual limits on elective deferrals, deferrals under an eligible deferred compensation plan, and catch-up contributions to 2004.

Under the proposal, the annual limit on elective deferrals generally is $15,000, the annual limit on elective deferrals under SIMPLE plans is $10,000, and the annual limit on deferrals under a section 457 plan is $15,000. These amounts are indexed for inflation after 2004.

In addition, in 2004, the annual limit on catch-up contributions to qualified cash or deferred arrangements, tax-sheltered annuities, salary reduction SEPs, and governmental section 457 plans is $5,000 and the annual limit on catch-up contribution to SIMPLE plans is $2,500. These amounts are indexed for inflation after 2004.

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[2] Pub. L. No. 107-16. The provisions of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") generally do not apply for years beginning after December 31, 2010.

Effective Date

The proposal is effective for years beginning after December 31, 2003.

B. Acceleration of Scheduled Increases in IRA Contribution Limits

Present Law

Under present law, the maximum annual dollar limit on contributions to individual retirement arrangements ("IRAs") is $3,000 for 2002-2004, $4,000 for 2005-2007, and $5,000 for 2008, with indexing thereafter.[3]

Under EGTRRA, individuals who have attained age 50 may make additional "catch up" contributions to IRAs of up to $500 in 2002-2005 and $1,000 in 2006 and thereafter.[4]

Description of Proposal

The proposal accelerates the increase in the maximum annual dollar limit on contributions to IRAs so that the limit is $5,000 for 2004 and thereafter. The $5,000 limit is indexed for inflation after 2004.[5]

The proposal also accelerates the increase in the catch-up contribution limit so that it is $1,000 for 2004 and thereafter.[6]

Effective Date

The provision is effective for taxable years beginning after December 31, 2003.

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[3] Contributions to IRAs are limited to the lesser of the maximum annual dollar limit or the individual's compensation. Sec. 219(b). In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. Sec. 219(c). For years after 2010, the maximum annual dollar limit is $2,000, pursuant to the general sunset provision of EGTRRA.

[4] The provisions of EGTRRA, including the catch-up provision, generally do not apply for years beginning after December 31, 2010.

[5] The limit remains subject to the general sunset of EGTRRA and reverts to $2,000 after 2010.

[6] Catch up contributions remain subject to the general sunset of EGTRRA and do not apply for years beginning after December 31, 2010.

C. Extension and Expansion of the Saver's Credit

Present Law

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions.[7] The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Joint returns with AGI of $50,000 or less, head of household returns of $37,500 or less, and single returns of $25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a SIMPLE,[8] or a simplified employee pension ("SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax sheltered annuity or qualified retirement plan.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any plan or IRA to which eligible contributions can be made during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year for which the credit is claimed and prior to the due date for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.[9]

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[7] Sec. 25B.

[8] Certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan.

[9] Certain other types of distributions do not reduce the credit (e.g., loans treated as deemed distributions).

The credit rates based on AGI are provided in Table 1, below.

Table 1.–Credit Rates Based on AGI

Joint Filers	*Heads of Households*	*All Other Filers*	*Credit Rate*
$0-$30,000	$0-$22,500	$0-$15,000	50 percent
$30,001-$32,500	$22,501-$24,375	$15,001-$16,250	20 percent
$32,501-$50,000	$24,376-$37,500	$16,251-$25,000	10 percent
Over $50,000	Over $37,500	Over $25,000	0 percent

The credit does not apply to taxable years beginning after December 31, 2006.

<u>Description of Proposal</u>

The proposal extends the saver's credit through 2010. Under the proposal, the credit does not apply for taxable years beginning after December 31, 2010.

The proposal also increases the AGI limits and credit percent rates as provided in Table 2, below.

Table 2.–Credit Rates Based on AGI

Joint Filers	*Heads of Households*	*All Other Filers*	*Credit Rate*
$0-$30,000	$0-$22,500	$0-$15,000	50 percent
$30,001-$40,000	$22,501-$30,000	$15,001-$20,000	20 percent
$40,001-$50,000	$30,001-$37,500	$20,001-$25,000	10 percent
Over $50,000	Over $37,500	Over $25,000	0 percent

Under the proposal, the AGI amounts are indexed beginning in 2009.

<u>Effective Date</u>

The proposal is effective for taxable years beginning after December 31, 2006.

D. Faster Vesting of Employer Nonelective Contributions

Present Law

Under present law, in general, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.[10]

Faster vesting schedules apply to employer matching contributions. Employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.

Description of Proposal

The proposal applies the present-law vesting schedule for matching contributions to all employer contributions to defined contribution plans.

Effective Date

The proposal is effective for contributions (including allocations of forfeitures) for plan years beginning after December 31, 2003, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

[10] The minimum vesting requirements are also contained in Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

E. Allow Transfers to Spouse's Retirement Plans

Present Law

Under present law, the transfer of an interest in an individual retirement arrangement ("IRA") to the spouse or former spouse of the IRA owner under a divorce or separation instrument is not a taxable transfer for Federal income tax purposes. After such a transfer, the IRA is treated as the IRA of the spouse or former spouse.[11]

An interest in an IRA may also be transferred to a spouse or former spouse upon the death of the IRA owner. In such cases, the IRA may also be treated as the IRA of the spouse or former spouse.

Description of Proposal

The proposal provides that the transfer of an interest in an IRA to the spouse of the IRA owner (or the former spouse pursuant to a divorce or separation instrument) is not a taxable transfer. Thus, an IRA owner may transfer an interest in the IRA to the owner's current spouse at any time.

Effective Date

The proposal applies to years beginning after the date of enactment.

[11] Sec. 408(d)(6).

F. Rollovers by Nonspouse Beneficiaries

Present Law

Tax-free rollovers

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity "section 403(b) annuity"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457 plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed. However, eligible rollover distributions may be rolled over tax free within 60 days to another plan, annuity, or IRA.[12]

In general, an eligible rollover distribution includes any distribution to the plan participant or IRA owner other than certain periodic distributions, minimum required distributions, and distributions made on account of hardship.[13] Distributions to a participant from a qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan generally can be rolled over to any of such plans or an IRA.[14] Similarly, distributions from an IRA to the IRA owner generally are permitted to be rolled over into a qualified retirement plan, a tax-sheltered annuity, a governmental section 457 plan, or another IRA.

Similar rollovers are permitted in the case of a distribution to the surviving spouse of the plan participant or IRA owner, but not to other persons.

If an individual inherits an IRA from the individual's deceased spouse, the IRA may be treated as the IRA of the surviving spouse. This treatment does not apply to IRAs inherited from someone other than the deceased spouse. In such cases, the IRA is not treated as the IRA of the beneficiary. Thus, for example, the beneficiary may not make contributions to the IRA and cannot roll over any amounts out of the inherited IRA. Like the original IRA owner, no amount is generally included in income until distributions are made from the IRA. Distributions from the inherited IRA must be made under the rules that apply to distributions to beneficiaries, as described below.

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[12] The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Sec. 402(c)(3)(B).

[13] Sec. 402(c)(4). Certain other distributions also are not eligible rollover distributions, e.g., corrective distributions of elective deferrals in excess of the elective deferral limits and loans that are treated as deemed distributions.

[14] Some restrictions or special rules may apply to certain distributions. For example, after-tax amounts distributed from a plan can be rolled over only to a plan of the same type or to an IRA.

Minimum distribution rules

Minimum distribution rules apply to tax-favored retirement arrangements. In the case of distributions prior to the death of the participant, distributions generally must begin by the April 1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70-1/2 or (2) retires.[15] The minimum distribution rules also apply to distributions following the death of the participant. If minimum distributions have begun prior to the participant's death, the remaining interest generally must be distributed at least as rapidly as under the minimum distribution method being used prior to the date of death. If the participant dies before minimum distributions have begun, then either (1) the entire remaining interest must be distributed within five years of the death, or (2) distributions must begin within one year of the death over the life (or life expectancy) of the designated beneficiary. A beneficiary who is the surviving spouse of the participant is not required to begin distributions until the date the deceased participant would have attained age 70-1/2. In addition, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, the minimum distribution rules apply separately to the surviving spouse.

In practice, many plans provide that distributions to a beneficiary who is not the surviving spouse are paid out immediately following the death of plan participant.

Description of Proposal

The proposal provides that benefits of a beneficiary other than a surviving spouse may be transferred directly to an IRA. The IRA is treated as an inherited IRA of the nonspouse beneficiary. Thus, for example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The proposal applies to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

Effective Date

The proposal is effective for distributions made after December 31, 2003.

[15] In the case of five-percent owners and distributions from an IRA, distributions must begin by the April 1 of the calendar year in which the individual attains age 70-1/2.

G. Rollover of After-Tax Amounts to Annuity Contracts

Present Law

Employee after-tax contributions may be rolled over from a tax-qualified retirement plan into another tax-qualified retirement plan, if the plan to which the rollover is made is a defined contribution plan, the rollover is accomplished through a direct rollover, and the plan to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions can also be rolled over from a tax-sheltered annuity (a "section 403(b) annuity") to another tax-sheltered annuity if the rollover is a direct rollover, and the annuity to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions may also be rolled over to an IRA. If the rollover is to an IRA, the rollover need not be a direct rollover and the IRA owner has the responsibility to keep track of the amount of after-tax contributions.[16]

Description of Proposal

The proposal allows after-tax contributions to be rolled over from a qualified retirement plan to a tax-sheltered annuity (or from a tax-sheltered annuity to a qualified retirement plan). As under present law, the rollover must be a direct rollover, and the plan to which the rollover is made must separately account for after-tax contributions (and earnings thereon).

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[16] Sec. 402(c)(2); IRS Notice 2002-3, 2002-2 I.R.B. 289.

H. IRA Eligibility for the Disabled

Present Law

Individuals may make annual contributions to individual retirement arrangements ("IRAs") generally limited to the lesser of $3,000 (for 2003) or the amount of the individual's compensation for the year. In the case of a married taxpayer filing a joint return, the contribution limit generally is the lesser of $3,000 (for 2003) or the combined compensation of the husband and wife. For this purpose, compensation means earned income and includes amounts includible in gross income as alimony or separate maintenance payments. It does not include any amount received as a pension or annuity or as deferred compensation

Description of Proposal

Under the proposal, an individual who is disabled and who has not attained age 70-1/2 before the end of the taxable year may make contributions to an IRA even if he or she has no compensation. For this purpose, an individual is considered disabled if he or she is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or to be of long-continued and indefinite duration.[17]

Effective Date

The proposal is effective for taxable years beginning after December 31, 2003.

[17] Sec. 72(m)(7). An individual is not considered to be disabled unless he or she furnishes proof of the existence of the disability in such form and manner as the Secretary may require.

I. Exclusion of Percentage of Lifetime Annuity Payments

Present Law

Under present law, distributions from qualified plans and similar employer-sponsored retirement plans and withdrawals from traditional individual retirement arrangements ("IRAs") are includible in gross income when received, except to the extent the distribution is a return of the individual's investment in the contract (i.e., basis). An individual would have basis under a qualified plan or traditional IRA, for example, if the individual made after-tax employee contributions to plan or nondeductible contributions to the IRA. If certain requirements are satisfied, qualified distributions from a Roth IRA are not includible income.

Description of Proposal

The proposal provides for the exclusion of a portion of the first five years of "lifetime annuity payments" received under qualified plans and similar employer-sponsored retirement plans (other than defined benefit plans) and IRAs. The exclusion applies to amounts distributed to "qualified distributes", meaning the plan participant (or IRA owner), the surviving spouse of the participant (or IRA owner), or an alternate payee under a qualified domestic relations order who is the spouse or former spouse of the participant.[18]

The maximum amount of life time annuity payments that may be excluded in a taxable year is equal to 10 percent of lifetime annuity payments received during the taxable year not in excess of one-half of the defined contribution plan dollar limit[19] in effect for the taxable year ($40,000 for 2003). Thus, assuming the defined contribution plan dollar limit remains $40,000 in 2004, the maximum amount of lifetime annuity payments that could be excluded under the provision is 2004 is $2,000 (10% x $20,000).

The maximum annual excludable amount (e.g., $2,000 for 2004) is phased out for individuals with adjusted gross income[20] in excess of certain amounts. The maximum excludable amount is phased out for married taxpayers filing joint returns with adjusted gross income between $120,000 and $150,000 and for other taxpayers (other than married taxpayers

[18] The exclusion does not apply to distributions to nonspouse beneficiaries of deceased plan participants or IRA owners.

[19] Sec. 415(c)(1)(A).

[20] Adjusted gross income for this purpose is defined generally as under the rules relating to IRAs, and is determined after the application of the rules relating to taxation of social security benefits (sec. 86) and limits on passive activity losses (sec. 469) and without regard to the exclusion for interest on education savings bonds (sec. 135), the exclusion for adoption assistance (sec. 137), the deduction for interest on education loans (sec. 221), the deduction for higher education expenses (sec. 222), the exclusion for foreign earned income (sec. 911), and the deduction for IRA contributions (sec. 219). In addition, gross income for this purpose does not include amounts includible in income due to the conversion of a traditional IRA into a Roth IRA.

filing a joint return) with adjusted gross income between $60,000 and $75,000.[21] Starting in 2005, the $60,000 number would be indexed for inflation in $5,000 increments, and the phase-out range for married taxpayers filing a joint return will be adjusted so that it remains double that for single taxpayers.

The exclusion amount, as reduced by the income phase-out, is not reduced below $200 until the exclusion amount is reduced to zero. Any income-adjusted exclusion amount which is not a multiple of $10 is rounded to the next lowest multiple of $10.

A "lifetime annuity payment" means a distribution which is part of a serious of substantially equal periodic payments made (not less frequently than annually over the life of the qualified distributee or the lives of the qualified distributee and his or her beneficiary. Annuity payments do not fail to be treated as substantially equal periodic payments merely because the amount of the payments may vary in accordance with investment experience, reallocations among investment options, actuarial gains or losses, cost of living indices or similar fluctuating criteria. The availability of a commutation benefit, a minimum period of payments certain, or a minimum amount to be paid in any even does not affect the treatment of a distribution as a lifetime annuity payment. Lifetime annuity payments made to a qualified retirement plan are treated as lifetime annuity payments made to a qualified distributee if the entire amount received by the trust with respect to a qualified distributee are paid to such distribute.

If a series of payments to which the exclusion applies is modified (other than by reason of death or disability) so that some or all future payments are not lifetime annuity payments, then the qualified distribute is required to include in income for the year of the modification an amount (determined under rules prescribed by the Secretary) equal to the amount that would have been includible in gross income but for the exclusion, plus interest for the deferral period. The deferral period means the period beginning with the taxable year the payment would have been includible in income (but for the exclusion) and ending with the taxable year in which the modification occurs. An interest rate needs to be specified.

Effective Date

The provision is effective for taxable years beginning after December 31, 2003.

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[21] The phase-out range for married taxpayer filing separate returns is $0 to $15,000. For purposes of the phase-out ranges, married taxpayers who live apart for the entire taxable year and who file separate returns are not treated as married.

II. REVITALIZING DEFINED BENEFIT PLANS

A. Treatment of Employee Contributions to Contributory Defined Benefit Plans

Present Law

Defined benefit plans may provide for employee contributions. Plans that provide for such contributions are referred to as "contributory" defined benefit plans. Generally, employee contributions to a defined benefit plan are made on an after-tax basis.[22] That is, employee contributions are includible in gross income and are wages for employment tax purposes.[23]

Accrued benefits attributable to employee contributions must be fully vested.[24] Mandatory contributions to a defined benefit plan are employee contributions required as a condition of employment, as a condition of the employee's participation in the plan, or as a condition of obtaining benefits (or additional benefits) attributable to employer contributions.[25] For purposes of the vesting requirements, the accrued benefit attributable to mandatory contributions is the annuity that is the actuarial equivalent of the total mandatory contributions made by the employee plus interest at a specified statutory rate. In the case of employee contributions to a defined benefit that are maintained in a separate account, to which income, expenses, gains, and losses are allocated (referred to as "voluntary" employee contributions), benefits attributable to the employee contributions are based on the balance of the separate account. The separate account maintained for voluntary employee contributions is treated as a defined contribution plan for certain purposes.[26]

Under a general nondiscrimination requirement, contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.[27] Treasury regulations provide rules for applying the nondiscrimination requirements to a defined benefit plan that provides for mandatory employee contributions.[28]

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[22] Special rules apply to certain employee contributions to a defined benefit plan maintained by a State or local government employer (sec. 414(h)(2)).

[23] Employment taxes generally include income tax withholing, taxes under the Federal Insurance Contributions Act ("FICA"), and taxes under the Federal Unemployment Tax Act ("FUTA").

[24] Sec. 411(a)(1).

[25] Sec. 411(c)(2)(C); Treas. Reg. sec. 1.411(c)-1(c)(4).

[26] Sec. 414(k).

[27] Sec. 401(a)(4).

[28] Treas. Reg. sec. 1.401(a)(4)-6(b).

Present law applies limits on the amount of annual additions made with respect to an employee to a qualified retirement plan.[29] Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to the employee. Employer contributions to qualified retirement plans are deductible subject to certain limits.[30] Employee contributions are not taken into account in applying these deduction limits.

Description of Proposal

Under the proposal, qualified mandatory employee contributions to certain defined benefit plans (other than governmental plans) are not includible in the employee's gross income for the year of contribution. Qualified mandatory employee contributions are mandatory contributions[31] that do not exceed two percent of compensation[32] and that are made pursuant to the terms of a defined benefit plan that meets certain requirements as in effect on January 1, 2003 (determined without regard to any plan amendments made after such date). Specifically, the plan must: (1) require employee contributions as a condition of participation in the plan; (2) allow an employee to make a one-time, irrevocable election to participate in the plan; and (3) not provide for employee contributions, with respect to which a separate account is maintained that is treated as a defined contribution plan.

Because qualified mandatory employee contributions are not includible in income, the proposal also provides that they are not wages for purposes of income tax withholding. Qualified mandatory employee contributions continue to be subject to FICA and FUTA taxes as under present law. In addition, because the contributions are not currently includible in income, the employee does not receive basis as a result of the contributions, so benefits attributable to the contributions are includible in income at the time of distribution.

The proposal changes only the time at which qualified mandatory employee contributions are included in an employee's gross income (i.e., at the time of distribution rather than at the time of contribution). The contributions continue to be characterized as employee contributions for other purposes and are subject to the same treatment as under present law, for example, for plan qualification purposes and for purposes of the limits on deductible employer contributions. In addition, mandatory contributions (and other employee contributions) that are not qualified mandatory employee contributions (e.g., mandatory contributions in excess of two percent of compensation) are includible in gross income as provided under present law.

Effective Date

The proposal applies to contributions made in years beginning after December 31, 2003.

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[29] Sec. 415.

[30] Sec. 404.

[31] Mandatory contributions are defined as under the vesting rules.

[32] Compensation is defined as under the rules relating to limits on contributions and benefits (sec. 415(c)(3)).

B. Reform of the Minimum Participation Rule

Present Law

Under the minimum participation rule, a defined benefit plan generally must benefit at least the lesser of (1) 50 employees of the employer, or (2) 40 percent of all employees of the employer.[33]

For purposes of the minimum participation rule, employees of a controlled group of corporations (or other businesses under common control) or of an affiliated service group are treated as employees of a single employer.[34] Under a special rule for a business acquisition or disposition, if a business becomes or ceases to be a member of a controlled group or an affiliated service group, a plan is treated as meeting the requirements of the minimum participation rule for a transition period if (1) the minimum participation requirements were met before the acquisition or disposition, and (2) the coverage under the plan is not significantly changed during the transition period (other than by reason of the change in members of the controlled group or affiliated service group). The transition period is the period beginning with the date of the acquisition or disposition and ending on the last day of the first plan year beginning after the date of the acquisition or disposition.

Description of Proposal

Under the proposal, the special rule for a business acquisition or disposition is modified so that a plan that is otherwise eligible for the rule is treated as meeting the minimum participation requirements for the transition period or such longer period as may be prescribed by the Secretary of Treasury.

Effective Date

The proposal is effective on the date of enactment.

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[33] Sec. 401(a)(26).

[34] The minimum participation rule may be applied separately with respect to each separate line of business of an employer. Secs. 401(a)(26)(G) and 414(r).

C. Temporary Replacement of Interest Rate on 30-Year Treasury Securities

Present Law

Funding in general

Defined benefit pension plans are subject to both minimum and maximum[35] funding requirements. Under the minimum funding rules, the amount of contributions required for a plan year is generally the plan's normal cost for the year (i.e., the cost of benefits allocated to the year under the plan's funding method) plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit.

Additional contributions for underfunded plans

Under a special funding rule,[36] additional contributions to a plan are generally required if the plan's funded current liability percentage is less than 90 percent.[37] A plan's "funded current liability percentage" is the value of plan assets as a percentage of the plan's current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan.

If a plan is subject to the special rule, an additional contribution, called a "deficit reduction contribution," is required. The amount of the deficit reduction contribution for a plan year is based on a variety of elements. In general, however, the deficit reduction contribution includes the amount equal to 30 percent of unfunded liabilities.[38] This amount is reduced if the plan's funded current liability percentage is greater than 60 percent. Other factors that affect the amount of the deficit reduction contribution include whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or due to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably

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[35] The maximum funding requirement for a defined benefit plan is referred to as the full funding limitation. Additional contributions are not required if a plan has reached the full funding limitation.

[36] The rule applies to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

[37] Under an alternative test, a plan is not subject to the special rule for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

[38] Only "new" unfunded liabilities are subject to this rule. "New" unfunded liabilities do not include certain liabilities as of 1988 or 1995.

predictable, such as facility shutdowns or reductions in workforce). In any case, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

Required interest rate

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.[39] The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[40] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.

The permissible range is generally from 90 percent to 105 percent.[41] The IRS publishes the applicable rate on a monthly basis. The Department of the Treasury does not currently issue 30-year Treasury securities. As of March 2002, the IRS publishes the average yield on the 30-year Treasury bond maturing in February 2031 as a substitute. The Secretary of the Treasury is required to prescribe mortality tables and to periodically review (at least every five years) and update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[42]

The Job Creation and Worker Assistance Act of 2002[43] amended the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements. Under this provision, the permissible range is from 90 percent to 120 percent for plan years beginning after December 31, 2001, and before January 1, 2004.[44]

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[39] Sec. 412(b)(5)(B)(iii)(II).

[40] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period.

[41] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

[42] Sec. 412(l)(7)(C).

[43] Pub. L. No. 107-147.

[44] In connection with the expanded interest rate range available for 2002 and 2003, special rules apply in determining current liability for the preceding plan year for plan years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability

Timing of plan contributions

In general, plan contributions required to satisfy the funding rules must be made within 8½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year.

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.

PBGC premiums

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. The Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans (up to certain limits) in the event the plan is terminated with insufficient assets. Employers pay premiums to the PBGC for this insurance coverage.

PBGC premiums include a flat-rate premium and, in the case of an underfunded plan, a variable rate premium based on the amount of unfunded vested benefits. In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Under the Job Creation and Worker Assistance Act of 2002,[45] for plan years beginning after December 31, 2001, and before January 1, 2004, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

Lump-sum distributions

Accrued benefits under a defined benefit plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form. Defined benefit plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.

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percentage for the preceding year, which may affect the need to make quarterly contributions, and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

[45] Pub. L. No. 107-147.

A defined benefit plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

Statutory assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum. That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the IRS) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of the time that is permitted under regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

Limits on benefits

Annual benefits payable under a defined benefit plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $160,000 (for 2003). The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning at age 65. If a benefit is payable in another form, the benefit must be adjusted to be actuarially equivalent to a straight life annuity that does not exceed the dollar limit. If the other form of benefit must be determined using the 30-year Treasury interest rate (e.g., a lump-sum benefit), that interest rate must also be used in making the adjustment.

Description of Proposal

The proposal changes the interest rate used for purposes of funding requirements and PBGC premiums for plan years beginning after December 31, 2003, and before January 1, 2007. The proposal changes the interest rate used for purposes of determining lump-sum distributions for plan years beginning after December 31, 2005, and before January 1, 2007. For these purposes, the proposal replaces the 30-year Treasury rate with the rate of interest on amounts conservatively invested in long-term corporate bonds.[46]

Under the proposal, the Secretary of the Treasury is directed to prescribe by regulations a method for determining the rate of interest on amounts conservatively invested in long-term corporate bonds, based on one or more indices, as determined from time to time by the Secretary.

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[46] Thus, for plan years beginning after December 31, 2003, the interest rate used for determining a plan's current liability must be within a permissible range of the weighted average of the rate of interest on amounts conservatively invested in long-term corporate bonds for the four-year period ending on the last day before the plan year begins.

For purposes of determining lump-sum distributions, the interest rate is phased-in for the plan year beginning in 2006. For such year, the applicable interest rate is the lower of (1) the interest rate based on amounts conservatively invested in long-term corporate bonds or (2) the 30-year Treasury rate plus the 20 percent of the excess of the interest rate based on amounts conservatively invested in long-term corporate bonds over the 30-year Treasury rate.

Under the proposal, in adjusting a benefit in a form other than a straight life annuity for purposes of determining the annual benefit limit under a defined benefit plan, an interest rate of 5.5 percent is required to be used.

Effective Date

The proposal is generally effective for plan years beginning after December 31, 2003, and before January 1, 2007.

For determining lump sum distributions, the proposal is generally effective for plan years beginning after December 31, 2005, and before January 1, 2007.

D. Updating Deduction Rules for Combination of Plans

Present Law

Employer contributions to qualified retirement plans are deductible subject to certain limits.[47] In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding requirement of the plan for the year. In addition, in order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program. Contributions in excess of the full funding limit are generally not deductible.[48]

In the case of a defined contribution plan, the employer generally may deduct contributions in an amount up to 25 percent of compensation paid or accrued during the employer's taxable year.

If an employer sponsors one or more defined benefit plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year.[49] The overall deduction limit generally is the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year (or the amount of either the plan's unfunded current liability or the plan's unfunded termination liability in the case of a terminating plan).

Elective deferrals are not subject to the limits on deductions and are not taken into account in applying the limits to other employer contributions.[50] The combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.[51] Certain contributions to a defined contribution plan that are

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[47] Sec. 404.

[48] Sec. 412(c)(6) and (c)(7).

[49] Sec. 404(a)(7).

[50] Sec. 404(n). The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[51] Sec. 4972.

nondeductible solely because of the overall deduction limit are disregarded in determining the amount of nondeductible contributions for purposes of the excise tax. Contributions that are disregarded are the greater of (1) the amount of contributions not in excess of six percent of the compensation of the employees covered by the defined contribution plan, or (2) the sum of matching contributions and elective deferrals.

Description of Proposal

Under the proposal, the overall limit on employer deductions for contributions to combinations of defined benefit and defined contribution plans applies to contributions to one or more defined contribution plans only to the extent that such contributions exceed six percent of compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plans.

In addition, under the proposal, for purposes of determining the excise tax on nondeductible contributions, matching contributions to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded.

Effective Date

The proposal is effective for contributions for taxable years beginning after December 31, 2003.

III. EXPANDING RETIREMENT PLAN COVERAGE TO EMPLOYEES OF SMALL BUSINESSES

A. Allow Additional Nonelective Contributions to SIMPLE Plans

Present Law

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA") for each employee or part of a qualified cash or deferred arrangement (a section "401(k) plan"). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans (including the top-heavy rules) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules continue to apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

A SIMPLE retirement plan allows employees to make pre-tax elective contributions, subject to a limit of $8,000 for 2003 (gradually increasing to $10,000 for 2005).[52] An individual who attains age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of $1,000 for 2003 (gradually increasing to $2,500 for 2006).[53] These dollar limits will be indexed for inflation after 2006 in $500 increments.

Employer contributions to a SIMPLE plan must satisfy one of two contribution formulas. Under the matching contribution formula, the employer generally is required to match employee elective contributions on a dollar-for-dollar basis up to three percent of the employee's compensation. Under a special rule applicable to SIMPLE IRAs, the employer can elect a lower percentage matching contribution for all employees (but not less than one percent of each employee's compensation). In addition, a lower percentage matching contribution cannot be elected for more than two years in the five-year period ending in the current year.

Alternatively, for any year, an employer is permitted to elect, in lieu of making matching contributions, to make a nonelective contribution of two percent of compensation on behalf of

[52] For years after 2010, the limit is $6,500, pursuant to the general sunset provision of EGTRRA.

[53] The provisions of EGTRRA, including the catch-up provision, generally do not apply for years beginning after December 31, 2010.

each eligible employee with at least $5,000 in compensation for such year, whether or not the employee makes an elective contribution.[54]

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan. All contributions to an employee's SIMPLE account must be fully vested.

Contributions to a SIMPLE plan generally are deductible by the employer and excludable from the employee's income. Early withdrawals from a SIMPLE plan generally are subject to the 10-percent early withdrawal tax. However, in the case of a SIMPLE IRA, withdrawals of contributions during the two-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to a 25-percent early withdrawal tax.

Description of Proposal

Under the proposal, an employer may make nonelective contributions to a SIMPLE plan in addition to the employer matching or nonelective contributions required under present law. Specifically, the employer may make additional nonelective contributions of a uniform percentage of compensation, up to 10 percent, for all employees in the plan who annually earn at least $5,000 from the employer.

Effective Date

The proposal is effective for years beginning after December 31, 2003.

[54] In general, nonelective contributions are employer contributions (other than matching contributions) made without regard to whether the employee makes contributions to the plan and which the employee may not elect to be paid in cash.

B. Conform Matching Contribution Rules for SIMPLE IRAs and SIMPLE 401(k)s

Present Law

In general

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA") for each employee or part of a qualified cash or deferred arrangement (a section "401(k) plan"). If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans (including the top-heavy rules) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules continue to apply. Within limits, contributions to a SIMPLE plan are not taxable until withdrawn.

The rules applicable to SIMPLE IRAs and SIMPLE 401(k) plans are similar, but not identical. SIMPLE plans are deemed to satisfy the nondiscrimination requirements applicable to qualified retirement plans and are deemed to satisfy the top-heavy rules.

In addition to SIMPLE plans, present law provides two additional plans to which elective deferrals may be made: 401(k) plans and tax-sheltered annuities.[55] All employers, other than State or local government employers, may maintain a 401(k) plan.[56] Tax-sheltered annuities ("section 403(b) annuities") may be maintained by certain tax-exempt employers and educational institutions. These arrangements are subject to different sets of rules, including limits on contributions, eligibility requirements, and nondiscrimination rules.

Eligible employers

Both SIMPLE IRAs and SIMPLE 401(k) plans are available to employers with 100 or fewer employees who do not maintain a qualified retirement plan. However, SIMPLE IRAs may

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[55] For taxable years beginning before January 1, 1997, employers with fewer than 25 employees could maintain a salary reduction simplified employee pension ("SARSEP") under which employees could elect to have contributions made to the plan or to receive the contributions in cash. Sec. 408(k). Salary reduction contributions generally may be made to SARSEPs which were established before 1997 (in accordance with the rules in effect before 1997). In addition, employees hired after December 31, 1996, generally may participate in SARSEPs established by their employers prior to January 1, 1997.

[56] Present law generally prohibits State and local government employers from establishing 401(k) plans. This prohibition does not apply in the case of a 401(k) plan adopted by a State or local government before May 6, 1986.

be established by State or local government employers, whereas 401(k) plans, including SIMPLE 401(k) plans, generally may not be established by State or local government employers.[57]

Eligible employees

In the case of a SIMPLE IRA, the group of eligible employees must include any employee who has received at least $5,000 in compensation from the employer in any two preceding years and is reasonably expected to receive $5,000 in the current year. The employer may choose to exclude certain nonresident aliens and collectively bargained employees. The group of employees eligible to participate in a SIMPLE 401(k) plan must satisfy the coverage requirements generally applicable to qualified retirement plans under section 410(b). These coverage requirements allow employers greater flexibility in determining which employees are eligible for a SIMPLE 401(k) than do the eligibility rules for SIMPLE IRAs.

Contribution requirements

All employees eligible to participate in a SIMPLE IRA or SIMPLE 401(k) must be permitted to make elective deferrals under the plan, up to a maximum of $8,000 (for 2003).[58] In addition, the employer must match employees' elective deferrals on a dollar-for-dollar basis up to three percent of compensation, or the employer must make a two-percent nonelective contribution for all eligible employees. In the case of SIMPLE IRAs, but not SIMPLE 401(k) plans, the employer may make matching contributions at a rate of less than three percent, but not less than one percent and may not make a reduced matching contribution for more than two years in the five-year period ending in the current year.

No contributions other than employee elective contributions, required employer matching contributions or employer nonelective contributions can be made to a SIMPLE plan.

Description of Proposal

The proposal conforms the matching contribution rules for SIMPLE 401(k) plans to those for SIMPLE IRAs. Thus, under the proposal, employers who sponsor SIMPLE 401(k) plans may make matching contributions at a rate of less than three percent of compensation, but not less than one percent of compensation, for no more than two years in the five-year period ending in the current year.

Effective Date

The proposal applies to years beginning after December 31, 2003.

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[57] A State or local government with a pre-May 6, 1986, grandfathered 401(k) plan may adopt a SIMPLE 401(k) plan.

[58] For years after 2010, the limit is $6,500, pursuant to the general sunset provision of EGTRRA.

C. Correct Inconsistency in Compensation Limits for Simplified Employee Pensions

Present Law

In general

A simplified employee pension ("SEP") is an individual retirement arrangement ("IRA") that meets certain requirements. If these requirements are satisfied, then employer contributions made to the SEP on behalf of the employers' employees are excludable from gross income and wages for employment tax purposes.[59] Other than the rules applicable to employer contributions, SEPs are generally subject to the rules applicable to IRAs generally.

Employer contributions must be made to a SEP for each employee of the employer who (1) has attained age 21, (2) has performed services for the employer during at least three of the immediately preceding five years, and (3) received at least $450 (for 2003) in compensation from the employer for the year. SEP contributions may be made for an employee who is also a participant in one or more qualified retirement plans sponsored by the employer. However, SEP contributions are added to the employer's contributions made to other plans on the participant's behalf in applying the limits on contributions and benefits.

Effective for taxable years beginning before January 1, 1997, employers with fewer than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could elect to have contributions made to the plan or to receive the contributions in cash. The SARSEP rules were generally repealed with the adoption of SIMPLE plans. However, salary reduction contributions generally may be made to SARSEPs which were established before 1997 (in accordance with the rules in effect before 1997). In addition, employees hired after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.[60]

Limits on employer contributions to SEPs and qualified plans

In general, the limit on the amount of excludable employer contributions that may be made to a SEP is the lesser of (1) 25 percent of the employee's compensation from such employer includible in the employee's gross income for the year (determined without regard to the employer contributions to the SEP) or (2) $40,000 (for 2003).[61]

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[59] Sec. 408(k). A SEP may be established by an individual who owns the entire interest in an unincorporated trade or business or by a partnership.

[60] Amounts contributed as salary reductions under a SARSEP are not counted as compensation for purposes of the maximum amount of the employer's contribution. Salary reduction contributions to SARSEPs are subject to the same dollar limit as section 401(k) plans. For 2003, this amount is $12,000. An employee may also make contributions to the IRA being used to receive employer contributions under a SEP, in the same manner as any other IRA. The maximum annual limit on contributions to IRAs is $3,000 for 2003.

[61] Sec. 402(h)(2). Separate rules apply for determining the amount an employer may deduct for contributions made to a SEP.

In the case of a qualified defined contribution plan, the limit on annual additions is the lesser of (1) 100 percent of compensation and (2) $40,000 (for 2003).[62] For this purpose, compensation generally means the participant's compensation from the employer for the year that is includible in income, plus certain elective contributions that are not included in gross income (i.e., elective deferrals under a qualified cash or deferred arrangement or a tax-sheltered annuity, elective contributions under a section 457 plan, salary reduction contributions under a cafeteria plan, and certain qualified transportation fringe benefits).

Description of Proposal

The proposal conforms the definition of compensation for purposes of determining the maximum amount that an employer may contribute to a SEP to the definition which generally applies for purposes of the limits on contributions and benefits under defined contribution plans. Thus, under the proposal, compensation for purposes of the SEP contribution limits means compensation from the employer that is includible in income, plus certain elective contributions that are not included in gross income (i.e., elective deferrals under a qualified cash or deferred arrangement or a tax-sheltered annuity, elective contributions under a section 457 plan, salary reduction contributions under a cafeteria plan, and certain qualified transportation fringe benefits).

Effective Date

The proposal applies to taxable years beginning after December 31, 2003.

[62] Sec. 415(c)(1).

D. Allow Level Dollar Contributions to SEPs

Present Law

A simplified employee pension ("SEP") is an individual retirement arrangement ("IRA") that meets certain requirements.[63] In general, employer contributions to a SEP are required to be made on behalf of each employee who has attained age 21, has performed service for the employer during at least three of the immediately preceding five years, and received at least $450 (for 2003) in compensation from the employer for the year. Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP (a "SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of rules for SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997.

In general, if these requirements are satisfied, then (within limits) employer contributions made to the SEP on behalf of the employers' employees are excludable from gross income and wages for employment tax purposes.[64] An employer generally may contribute up to the lesser of (1) 25 percent of the employee's compensation or (2) $40,000 (for 2003) to a SEP for each employee.

Employer contributions to a SEP must not discriminate in favor of highly compensated employees.[65] In general, employer contributions are considered discriminatory unless they bear a uniform relationship to the first $200,000 (as indexed for inflation) of each employee's annual compensation.[66]

Description of Proposal

The proposal adds an alternative contribution formula under which employer contributions to a SEP are not considered discriminatory. Under the proposal, employer contributions to a SEP are not considered discriminatory if such contributions are a uniform dollar amount on behalf of each employee covered by the SEP or satisfy the present-law rule.

Effective Date

The proposal applies to years beginning after December 31, 2003.

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[63] Other than the rules applicable to employer contributions, SEPs are generally subject to the rules applicable to IRAs generally.

[64] Sec. 408(k). A SEP may be established by an individual who owns the entire interest in an unincorporated trade or business or by a partnership.

[65] Sec. 408(k)(3).

[66] Sec. 408(k)(3)(C). The permitted disparity rules may be applied in determining whether contributions are nondiscriminatory. Sec. 408(k)(3)(D).

E. Tax Treatment of Certain Nontrade or Business SEP Contributions

Present Law

In general

A business that employs fewer than 100 employees can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA") for each employee (a "SIMPLE IRA") or part of a defined contribution plan that includes a qualified cash or deferred arrangement under section 401(k) (a "SIMPLE section 401(k) plan").[67]

A simplified employee pension ("SEP") is an IRA to which employers may make excludable contributions up to the lesser of (1) 25 percent of the employee's compensation or (2) $40,000 (for 2003). In general, employer contributions to a SEP are required to be made on behalf of each employee who has attained age 21, has performed service for the employer during at least three of the immediately preceding five years, and received at least $450 (for 2003) in compensation from the employer for the year. Effective for taxable years beginning before January 1, 1997, certain employers with no more than 25 employees could maintain a salary reduction SEP (a "SARSEP") under which employees could make elective deferrals. The SARSEP rules were generally repealed with the adoption of rules for SIMPLE plans. However, contributions may continue to be made to SARSEPs that were established before 1997.

Employee contributions to SIMPLE plans and SEPs

Employees may make pre-tax elective contributions to SIMPLE plans. These contributions are subject to a limit of $8,000 for 2003 (gradually increasing to $10,000 for 2005). An individual who attains age 50 before the end of the taxable year may also make catch-up contributions to a SIMPLE plan up to a limit of $1,000 for 2003 (gradually increasing to $2,500 for 2006).[68] These dollar limits will be indexed for inflation after 2006 in $500 increments.[69]

Effective for taxable years beginning before January 1, 1997, employers with fewer than 25 employees could maintain a salary reduction SEP ("SARSEP") under which employees could elect to have contributions made to the plan or to receive the contributions in cash. However, salary reduction contributions generally may be made to SARSEPs which were established before 1997 (in accordance with the rules in effect before 1997). In addition, employees hired

[67] Secs. 401(k)(11) and 408(p).

[68] The provisions of EGTRRA, including the catch-up provision, generally do not apply for years beginning after December 31, 2010.

[69] These limits are subject to the general sunset provision of EGTRRA.

after December 31, 1996, may participate in SARSEPs established by their employers prior to January 1, 1997.[70]

Employer contributions to SIMPLE plans and SEPs

Present law permits employers to make deductible contributions, within certain limits, to SIMPLE plans and SEPs. Subject to certain exceptions, a 10-percent excise tax applies to nondeductible contributions to such plans.[71]

The 10-percent excise tax does not apply to contributions to a SIMPLE plan that are nondeductible solely because the contributions are not made in connection with a trade or business of the employer. Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax.

Description of Proposal

The proposal provides that the 10-percent excise tax on nondeductible contributions does not apply to contributions to a SEP that are nondeductible solely because the contributions are not a qualifying trade or business expense of the employer.

Effective Date

The proposal applies to years beginning after December 31, 2003.

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[70] Amounts contributed as salary reductions under a SARSEP are not counted as compensation for purposes of the maximum amount of the employer's contribution. Salary reduction contributions to SARSEPs are subject to the same dollar limit as section 401(k) plans. For 2003, this amount is $12,000. An employee may also make contributions to the IRA being used to receive employer contributions under a SEP, in the same manner as any other IRA. The maximum annual limit on contributions to IRAs is $3,000 for 2003.

[71] Sec. 4972.

IV. EXPANDING RETIREMENT SAVINGS OPPORTUNITIES FOR EMPLOYEES OF TAX-EXEMPT ORGANIZATIONS AND GOVERNMENTS

A. Inapplicability of 10-Percent Additional Tax on Early Distributions of Pension Plans of Public Safety Employees

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59-1/2, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Description of Proposal

Under the proposal, the 10-percent early withdrawal tax does not apply to distributions to a qualified safety employee from a governmental plan to the extent that such distributions are attributable to a DROP benefit. A DROP benefit is a feature of a governmental defined benefit plan under which an employee elects to receive credits to an account (including a notional account) in the plan which are not in excess of the plan benefits that would have been provided if the employee had retired under the plan at a specified earlier retirement date and which are in lieu of increases in the employee's accrued pension benefit under such defined benefit plan based on years of service after the effective date of the DROP election. The waiver of the penalty is available only to amounts that would have been payable as an annuity from the defined benefit plan had the individual retired and taken the defined benefit plan benefit.

A qualified public safety employee is an employee of any police department or fire department organized and operated by a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision and would have been eligible to retire on or before the effective date of the DROP election and receive an immediate retirement benefit under the defined benefit plan.

Effective Date

The proposal is effective for distributions made after the date of enactment.

B. Purchase of Permissive Service Credit

Present Law

In general

Present law imposes limits on contributions and benefits under qualified plans.[72] The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) a certain dollar amount ($160,000 for 2003) or (2) 100 percent of the participant's average compensation for his or her high three years.

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits.[73]

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

Permissive service credit

Definition of permissive service credit

Permissive service credit means credit for a period of service recognized by the governmental plan which the participant has not received under the plan and which the employee receives only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

The IRS has ruled that credit is not permissive service credit where it is purchased to provide enhanced retirement benefits for a period of service already credited under the plan, as the enhanced benefit is treated as credit for service already received.[74]

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[72] Sec. 415.

[73] Sec. 415(n)(3).

[74] Priv. Ltr. Rul. 200228051 (April 26, 2002).

Nonqualified service

Service credit is not permissive service credit if more than five years of permissive service credit is purchased for nonqualified service or if nonqualified service is taken into account for an employee who has less than five years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, State or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, as determined under State law, or (4) for military service. Service under (1), (2) and (3) is nonqualified service if it enables a participant to receive a retirement benefit for the same service under more than one plan.

Trustee-to-trustee transfers to purchase permissive service credit

A participant is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credit under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).

Description of Proposal

The proposal provides that the provisions regarding nonqualified service are not applicable to a trustee-to-trustee transfer from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan to purchase permissive service credit. That is, the limits on nonqualified service credit do not apply to such transfers. For purposes of the limits on benefits and contributions, the rules regarding nonqualified service are not modified.

The proposal also provides that amounts transferred from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan to purchase permissive service credit must be distributed in accordance with the qualification requirements for the defined benefit plan.

The proposal also modifies the definition of permissive service credit to provide that permissive service credit means service credit which relates to benefits to which the participant is not otherwise entitled, rather than service credit which such participant has not received under the plan. Credit qualifies as permissive service credit if it is purchased to provide an enhanced benefit for a period of service already credited under the plan (e.g., if a lower level of benefit is converted to a higher benefit level under the same plan) as long as it relates to benefits to which the participant is not otherwise entitled.

Effective Date

The proposal is effective as if included in section 631(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, i.e., for transfers after December 31, 2001.

C. Eligibility for Participation in Eligible Deferred Compensation Plans

Present Law

A section 457 plan is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers.

Amounts deferred under an eligible deferred compensation plan of a non-governmental tax-exempt organization are includible in gross income for the year in which amounts are paid or made available. Under present law, if the amount payable to a participant does not exceed $5,000, a plan may allow a distribution up to $5,000 without such amount being treated as made available if the distribution can be made only if no amount has been deferred under the plan by the participant during the two-year period ending on the date of the distribution and there has been no prior distribution under the plan. Prior to the Small Business Job Protection Act of 1996, under former section 457(e)(9), benefits were not treated as made available because a participant could elect to receive a lump sum payable after separation from service and within 60 days of the election if (1) the total amount payable under the plan did not exceed $3,500 and (2) no additional amounts could be deferred under the plan.

Description of Proposal

The proposal provides that an individual is not precluded from participating in an eligible deferred compensation plan by reason of having received a distribution under section 457(e)(9) as in effect before the Small Business Job Protection Act of 1996.

Effective Date

The proposal is effective on the date of enactment.

D. Application of Minimum Distribution Rules to Governmental Plans

Present Law

Minimum distribution rules apply to tax-favored retirement arrangements, including governmental plans. In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived in certain cases.

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations) beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions from account-type arrangements (e.g., a defined contribution plan or an individual retirement arrangement), life expectancies of the participant and the participant's spouse generally may be recomputed annually.

The required beginning date generally is April 1 of the calendar year following the later of (1) the calendar year in which the participant attains age 70-1/2[75] or (2) the calendar year in which the participant retires.

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if distributions begin within one year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distributions until the date the deceased participant would have attained age 70-1/2.

Description of Proposal

The proposal directs the Secretary of the Treasury to issue regulations under which a governmental plan is treated as complying with the minimum distribution requirements, for all years to which such requirements apply, if the plan complies with a reasonable, good faith interpretation of the statutory requirements. It is intended that the regulations apply for periods before the date of enactment.

[75] This age would be changed under another provision of the proposal.

Effective Date

The proposal is effective on the date of enactment.

E. Annual Benefits Under Church Plans

Present Law

Present law imposes limits on contributions and benefits under qualified retirement plans.[76] These limits are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) a certain dollar amount ($160,000 for 2003) or (2) 100 percent of the participant's average compensation for his or her high three years.[77] The dollar limit generally is adjusted for cost-of-living increases in $5,000 increments. The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

Description of Proposal

Under the proposal, the 100 percent of the compensation limitation on benefits under a defined benefit plan does not apply to church plans, except in the case of "highly compensated benefits."[78] For purposes of the proposal, highly compensated benefits are benefits accrued for an employee in any year on or after the first year in which such employee is a highly compensated employee. Thus, for benefits of an employee who has never been a highly compensated employee and benefits for years before an employee becomes a highly compensated employee, the maximum annual benefit payable at retirement under a defined benefit plan is limited only by the applicable dollar limit on benefits.

Under the proposal, church plans include plans of a church, a convention or association of churches, or an elementary or secondary school that is controlled, operated, or principally supported by a church or by a convention or association of churches.

Effective Date

The proposal is effective for plan years beginning after December 31, 2003.

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[76] Sec. 415.

[77] In the case of a governmental plan or a multiemployer plan, the 100 percent of compensation limit does not apply. Sec. 415(b)(11).

[78] For purposes of applying the limit to highly compensated benefits, all benefits of the employee otherwise taken into account without regard to the proposal are taken into account.

V. SIMPLIFICATION AND EQUITY

A. Updating of the Minimum Distribution Rules

Present Law

In general

Minimum distribution rules apply to tax-favored retirement arrangements, including qualified retirement plans and annuities, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) annuities"), and eligible deferred compensation plans of tax-exempt and State and local government employers ("section 457 plans"). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. An excise tax is imposed on the failure to comply with the minimum distribution rules. The excise tax is imposed on the plan participant and is equal to 50 percent of the required minimum distribution not distributed for the year.

Distributions prior to the death of the individual

In the case of distributions prior to the death of the plan participant, the minimum distribution rules are satisfied if either (1) the participant's entire interest in the plan is distributed by the required beginning date, or (2) the participant's interest in the plan is to be distributed (in accordance with regulations), beginning not later than the required beginning date, over a permissible period. The permissible periods are (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) the life expectancy of the participant, or (4) the joint life and last survivor expectancy of the participant and a designated beneficiary. In calculating minimum required distributions from account-type arrangements (e.g., a defined contribution plan or an individual retirement account), life expectancies of the participant and the participant's spouse generally may be recomputed annually.

In the case of qualified retirement plans, tax-sheltered annuities, and section 457 plans, the required beginning date generally is April 1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70-1/2 or (2) retires. However, in the case of a five-percent owner of the employer, distributions are required to begin no later than April 1 of the calendar year following the year in which the five-percent owner attains age 70-1/2. If commencement of distributions from a defined benefit plan to an individual other than a five-percent owner is delayed beyond age 70-1/2 (i.e., in the case of a participant who has not retired), then the accrued benefit of the participant must be actuarially increased to take into account the period after age 70-1/2 in which the participant was not receiving benefits under the plan.[79] Under temporary Treasury regulations, this period begins on the April 1 of the calendar year following the year in which the individual attains age 70-1/2.[80] In the case of distributions

[79] State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70-1/2.

[80] Temp. Treas. Reg. sec. 1.401(a)(9)-6T, Q&A 7(a).

from an IRA other than a Roth IRA, the required beginning date is the April 1 of the calendar year following the calendar year in which the IRA owner attains age 70-1/2. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution generally is determined by dividing the employee's benefit by the applicable distribution period provided in a uniform lifetime table in regulations.[81]

<u>Distributions after the death of the plan participant</u>

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if a participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if distributions begin within one year of the participant's death and are payable over the life or life expectancy of a designated beneficiary.

A surviving spouse beneficiary is not required to begin distributions until the date the deceased participant would have attained age 70-1/2. In addition, a surviving spouse generally has the option of rolling over his or her interest in the plan or IRA to a plan in which the spouse is a participant or to an IRA established for his or her benefit. In that case, the minimum distribution rules are applied to the plan or IRA on the basis of the surviving spouse's age.

<u>Excise tax on failure to make minimum distributions</u>

Under present law, an excise tax is imposed on the failure to make minimum distributions. The tax is nondeductible, and is equal to 50 percent of the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, over the amount that actually was distributed.[82] The tax is imposed on the individual required to take the distribution. The excise tax may be waived if the individual establishes to the satisfaction of the Secretary of the Treasury that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under Treasury regulations.

[81] Treas. Reg. sec. 1.401(a)(9)-9, Q&A 2.

[82] Sec. 4974.

Description of Proposal

The proposal increases the age at which distributions to a participant must begin (the "applicable age") to 72 in 2004 through 2007 and 75 in 2008 and thereafter. Thus, a participant generally is not required to begin receiving distributions until April 1 of the calendar year following the later of the calendar year in which the participant (1) attains the applicable age or (2) retires. In the case of a five-percent owner of the employer, distributions are required to begin no later than April 1 of the calendar year following the year in which the five-percent owner attains the applicable age. Under the proposal, the change in age also applies for purposes of distributions to surviving spouses.

The proposal revises the rule relating to actuarial adjustments to the accrued benefit under a plan when commencement of benefits is delayed beyond age 70-1/2 to reflect the new required beginning date under the proposal, and to incorporate the rule in temporary Treasury regulations regarding the beginning date of the adjustment period. Under the provision, a participant's accrued benefit under a defined benefit plan must be actuarially increased to take into account the period after April 1 of the calendar year in which the participant attains age 70-1/2 during which the participant is not receiving benefits under the plan.

Additionally, the proposal also decreases the excise tax on failure to make required distributions to 20 percent.

Effective Date

The proposal is generally effective for years beginning after December 31, 2003. Under a transition rule, a plan or IRA is not treated as failing to meet the minimum distribution requirements merely because, in years after 2003, it does not make a distribution before a participant's required beginning date as determined under the proposal. As a result, a participant who attains age 70-1/2 before 2004 need not receive distributions in years after 2003 unless he or she would have to receive distributions under the proposal. For example, a participant who attains age 70-1/2 in 2003 and who is required under present law to receive a distribution by April 1, 2004, may delay the distribution until his or her required beginning date as determined under the proposal. In addition, a participant who began receiving required distributions before 2004 and whose required beginning date under the proposal is after 2005, is not required to receive additional distributions until the required beginning date under the proposal.

B. Catch-Up Contributions

Present Law

Present law provides that the otherwise applicable dollar limit on elective deferrals under a qualified cash or deferred arrangement, tax-sheltered annuity, simplified employee pension ("SEP"), or SIMPLE,[83] or deferrals under an eligible deferred compensation plan of a State or local government (a "governmental section 457 plan") is increased to allow additional elective deferrals ("catch-up contributions") for individuals who will attain age 50 by the end of the taxable year[84] and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan.

The amount of catch-up contributions that may be made by an eligible individual is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year.[85] The applicable dollar amount under a qualified cash or deferred arrangement, tax-sheltered annuity, SEP, or governmental section 457 plan is $2,000 for 2003, $3,000 for 2004, $4,000 for 2005, and $5,000 for 2006 and thereafter. The applicable dollar amount under a SIMPLE is $1,000 for 2003, $1,500 for 2004, $2,000 for 2005, and $2,500 for 2006 and thereafter. The $5,000 and $2,500 amounts are adjusted for inflation in $500 increments in 2007 and thereafter.[86] Catch-up contributions are not subject to any other contribution limits and are not taken into account in applying other contribution limits.

A plan that allows catch-up contributions must allow all eligible individuals participating in the plan to make the same election with respect to catch-up contributions (referred to as the "universal availability requirement"). For purposes of this rule, all plans of related employers are treated as a single plan.[87] Catch-up contributions are not otherwise subject to nondiscrimination rules.

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[83] Certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan.

[84] An individual who will attain age 50 by the end of the taxable year is an eligible participant as of the beginning of the taxable year rather than only at the attainment of age 50.

[85] A participant in an eligible deferred compensation plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount permitted under the catch-up rule and the amount permitted under the special catch-up rule for eligible deferred compensation plans. Sec. 457(e)(18).

[86] The provisions of EGTRRA, including the catch-up provisions, generally do not apply after December 31, 2010.

[87] A special rule applies in the case of transactions (e.g., mergers and acquisitions) that cause the members of a controlled group to change.

Treasury regulations provide that an applicable employer plan does not fail to satisfy the universal availability requirement merely because employees covered by a collective bargaining agreement and nonresident aliens who receive no earned income from the employer from sources within the United States are not provided the opportunity to make catch-up contributions.[88] The IRS has issued a notice stating that, until the issuance of further guidance, a plan that permits catch-up contributions will not fail to satisfy the universal availability requirement solely because another plan maintained by the employer that is qualified under Puerto Rico law does not provide for catch-up contributions.[89]

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

Description of Proposal

The proposal provides that, in applying the universal availability requirement to catch-up contributions, employees covered by a collective bargaining agreement and nonresident aliens who receive no earned income from the employer from sources within the United States are disregarded. In addition, the universal availability requirement may be applied separately to separate lines of business. The proposal also provides that a plan will not fail to satisfy the universal availability requirement solely because another applicable employer plan maintained by the employer that is qualified under Puerto Rico law does not provide for catch-up contributions.

Effective Date

The proposal is effective as if included in section 631(a) of the Economic Growth and Tax Relief Reconciliation Act of 2001, i.e., for taxable years beginning after December 31, 2001.

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[88] Treas. Reg. sec. 1.414(v)-1(d)(4).

[89] Notice 2002-4, 2002-2 I.R.B. 298.

C. Transfers to the PBGC

Present Law

Involuntary distributions and automatic rollovers

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant (an "involuntary distribution") and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000.[90] Generally, a participant may roll over an involuntary distribution from a qualified plan to an individual retirement arrangement (an "IRA") or to another qualified plan.

In the case of an involuntary distribution that exceeds $1,000 and that is an eligible rollover distribution from a qualified retirement plan, the plan administrator must roll the distribution over to an IRA (an "automatic rollover") in certain cases.[91] That is, the plan administrator must make a direct trustee-to-trustee transfer of the distribution to an IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences. In the case of an automatic rollover to an IRA, the written explanation provided by the plan administrator is required to explain that an automatic rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred to another IRA.

Missing participant benefits

In the case of a defined benefit pension plan that is subject to the plan termination insurance program under Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA"), is maintained by a single employer, and terminates under a standard termination, the plan administrator generally must purchase annuity contracts from a private insurer to provide

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[90] The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested accrued benefit.

[91] Sec. 401(a)(31)(B). This provision was enacted by section 657 of EGTRRA and applies to distributions after the issuance of final regulations by the Department of Labor providing safe harbors for satisfying fiduciary requirements related to automatic rollovers. Such regulations are to be issued within three years after June 7, 2001, the date of enactment of EGTRRA. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

the benefits to which participants are entitled and distribute the annuity contracts to the participants.

If a participant whom the plan administrator of a terminating single employer plan cannot locate after a diligent search (a "missing participant"), the plan administrator may satisfy the distribution requirement only by purchasing an annuity from an insurer or transferring the participant's designated benefit to the Pension Benefit Guaranty Corporation ("PBGC"), which holds the benefit of the missing participant as trustee until the PBGC locates the missing participant and distributes the benefit.[92]

The PBGC missing participant program is not available to multiemployer plans or defined contribution plans and other plans not covered by Title IV of ERISA.

Description of Proposal

Automatic rollovers

The proposal provides an alternative to the automatic rollover to an IRA of an involuntary distribution that exceeds $1,000. Under the proposal, unless the participant elects to have the distribution transferred to an IRA or a qualified retirement plan or to receive it directly, the plan may provide for the transfer of the distribution to the PBGC, instead of to an IRA.[93] The written explanation provided to the participant by the plan administrator before the involuntary distribution must explain that a transfer to the PBGC will be made unless the participant elects otherwise.

The proposal extends the provisions relating to the PBGC missing participant program to involuntary distributions that are transferred to the PBGC. Benefits transferred to the PBGC under the proposal are to be distributed by the PBGC to the participant upon application filed by the participant with the PBGC in such form and manner as prescribed by the PBGC in regulations. Benefits are to be distributed in a single sum (plus interest) or in another form as specified in PBGC regulations.

The transfer of an involuntary distribution to the PBGC is treated as a transfer to an IRA (i.e., the amount transferred is not included in the participant's income). An amount distributed by the PBGC is generally treated as a distribution from an IRA.

Missing participant benefits

The PBGC is directed to prescribe rules for terminating multiemployer plans similar to the present-law missing participant rules applicable to terminating single-employer plans that are subject to Title IV of ERISA.

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[92] Secs. 4041(b)(3)(A) and 4050 of ERISA.

[93] The proposal applies to all automatic rollovers, not just those for missing participants.

In addition, plan administrators of certain types of plans not subject to the PBGC termination insurance program under present law are permitted, but not required, to elect to transfer missing participants' benefits to the PBGC upon plan termination. Specifically, the proposal extends the missing participants program (in accordance with regulations) to defined contribution plans, defined benefit plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

Effective Date

The proposal allowing a plan administrator to make an automatic rollover to the PBGC is effective as if included in the amendments made by section 657 of EGTRRA, i.e., after the issuance of final regulations by the Department of Labor. The proposal amending the PBGC missing participant program (including amendments related to automatic rollovers to the PBGC) is effective for distributions made after the PBGC issues final regulations implementing the proposal. It is expected that the Department of Labor and the PBGC will coordinate the timing of the regulations relating to automatic rollovers.

D. Allow Direct Rollovers from Retirement Plans to Roth IRAs

Present Law

IRAs in general

There are two general types of individual retirement arrangements ("IRAs"): traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs.

Traditional IRAs

An individual may make deductible contributions to an IRA up to the lesser of a dollar limit (generally $3,000 for 2003)[94] or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.[95] If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year. A different, higher, income phaseout applies in the case of an individual who is not an active participant in an employer sponsored plan but whose spouse is.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA.

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, or is used for certain specified purposes.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contributions that can be made to all an individuals IRAs (both traditional and Roth) cannot exceed the maximum deductible IRA contribution limit. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with income above certain levels.

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[94] The dollar limit is scheduled to increase until it is $5,000 beginning in 2008-2010. Individuals age 50 and older may make additional catch up contributions.

[95] In the case of a married couple, deductible IRA contributions of up to the dollar limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59-1/2, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

Rollover contributions

If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. Distributions from such plans may not be rolled over into a Roth IRA.

Taxpayers with modified AGI of $100,000 or less generally may roll over amounts in a traditional IRA into a Roth IRA. The amount rolled over is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. Married taxpayers who file separate returns cannot roll over amounts in a traditional IRA into a Roth IRA. Amounts that have been distributed from a tax-qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan may be rolled over into a traditional IRA, and then rolled over from the traditional IRA into a Roth IRA.

Description of Proposal

The proposal allows distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental 457 plans to be rolled over directly from such plan into a Roth IRA, subject to the present law rules that apply to rollovers from a traditional IRA into a Roth IRA. For example, a rollover from a tax-qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply. Similarly, an individual with AGI of $100,000 or more could not roll over amounts from a tax-qualified retirement plan directly into a Roth IRA.

Effective Date

The proposal is effective for distributions made after December 31, 2003.

E. Reform Excise Tax on Excess Contributions

Present Law

An excise tax is imposed on an employer making excess contributions or excess aggregate contributions to a qualified retirement plan.[96] Excess contributions are elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions, made on behalf of highly compensated employees to a plan which fails to satisfy the applicable nondiscrimination tests for such plan for the year.[97] Excess aggregate contributions are the aggregate amount of employer matching contributions and employee after-tax contributions for highly compensated employees to a plan failing to satisfy the applicable nondiscrimination tests for such plan for the year.[98]

The excise tax is equal to 10 percent of the excess contributions or excess aggregate contributions under a plan for the plan year ending in the taxable year. The tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within 2-1/2 months after the close of the plan year. Any excess contributions or excess aggregate contributions which are distributed within 2-1/2 months after the close of the plan year are treated as received and earned by the recipient in the taxable year for which such contributions are made. If the total of such distributions to a recipient under a plan for any plan year is less than $100, such distributions (and any income allocable thereto) are treated as earned and received by the recipient in the taxable year in which the distributions are made.

Additionally, in accordance with Treasury regulations, excess contributions may be recharacterized as after-tax employee contributions, no later than 2-1/2 months after the close of the plan year to which the excess contributions relate.[99]

Description of Proposal

Under the proposal, the excise tax does not apply to any excess contributions or excess aggregate contributions which, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within six months after the close of the plan year. Additionally, any excess contributions or excess aggregate contributions (and any income allocable thereto) which are distributed no later than six months after the close of the plan year to which the contributions relate are treated as received and earned by the recipient in the taxable year in which such distribution is made, regardless of the amount distributed.

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[96] Sec. 4979.

[97] Sec. 4979(c).

[98] Sec. 4979(d).

[99] Treas. Reg. sec. 1.401(k)-1(f)(3).

The Secretary of the Treasury should review the applicable regulations and conform them as appropriate.

Effective Date

The proposal is effective for years beginning after December 31, 2003.

F. Intermediate Sanctions for Inadvertent Failures

Present Law

In general

A retirement plan that is intended to be a tax-qualified plan provides retirement benefits on a tax-favored basis[100] if the plan satisfies all of the requirements of section 401(a). Retirement plans that contain qualified cash or deferred arrangements are subject to additional requirements under section 401(k). Similarly, an annuity that is intended to be a tax-sheltered annuity provides retirement benefits on a tax-favored basis if the program satisfies all of the requirements of section 403(b). Failure to satisfy all of the applicable requirements may make a plan or annuity (and the employer and employees) ineligible for the intended tax-favored treatment.

Sanctions for failure to meet qualification rules

Retirement plans

If a plan fails to meet the applicable qualification standards, then the special tax benefits for qualified retirement plans do not apply, and benefits and contributions are taxed under normal income tax rules. In general, if a plan fails to meet the qualification standards, then contributions to the plan are includible in the employees' gross income when such contributions are no longer subject to a substantial risk of forfeiture.[101] Amounts actually distributed or made available to an employee are generally includible in income in the year distributed or made available under the rules applicable to taxation of annuities.[102] An employer is generally not entitled to a deduction for contributions to a nonqualified plan until the contributions are includible in an employee's gross income.[103]

A special sanction applies to failures to satisfy the minimum participation rule and the minimum coverage rules. Under the minimum participation rule, a defined benefit plan generally must benefit at least the lesser of (1) 50 employees of the employer, or (2) 40 percent of all employees of the employer.[104]

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[100] Employees generally do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in the employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

[101] Secs. 83 and 402(b).

[102] Sec. 72.

[103] Sec. 404(a)(5).

[104] Sec. 401(a)(26).

Under the minimum coverage rules, a plan must satisfy one of three tests designed to ensure that the plan benefits a broad group of employees, not just highly compensated employees.[105] Under these rules, a plan must meet one of the following requirements: (1) the plan benefits at least 70 percent of employees who are nonhighly compensated employees; (2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan; or (3) the plan satisfies an average benefits test which compares the benefits received by highly compensated employees and nonhighly compensated employees.[106]

Under the special sanction, if one of the reasons a plan fails to be a qualified retirement plan is its failure to satisfy either the minimum participation rule or the minimum coverage rules, then highly compensated employees must include in income the value of their vested accrued benefit as of the close of the plan year in which the plan fails to qualify. If failure to satisfy the minimum participation rule or the minimum coverage rules is the only reason a plan fails to be a qualified retirement plan, then no amount is includible in income of nonhighly compensated employees by reason of such failure.

Tax-sheltered annuities

If a tax-sheltered annuity fails to satisfy applicable Code requirements, the tax consequences depend on whether it is funded by an annuity contract or a custodial account. In either case, the primary consequence generally is that the employee must include in gross income employer contributions made on the employee's behalf to the tax-sheltered annuity. In particular, if an annuity contract fails to satisfy applicable Code requirements, the employee generally is taxable under the rules for a nonqualified annuity.[107] In the case of a custodial account, the employee generally includes in gross income the employer's contributions and any earnings of the custodial account.

IRS compliance programs

The Internal Revenue Service ("IRS") has programs which are designed to ensure that plans comply the applicable requirements. These programs include: (1) the determination letter program; (2) the examination program; and (3) the Employee Plans Compliance Resolution System ("EPCRS").

[105] An employee is treated as highly compensated if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year, or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2003) or (b) at the election of the employer had compensation for the preceding year in excess of $90,000 (for 2003) and was in the top 20 percent of employees by compensation for such year. A nonhighly compensated employee is an employee other than a highly compensated employee. Sec. 414(q).

[106] Sec. 410(b).

[107] These rules are set forth in section 403(c).

Plan sponsors may voluntarily submit plans for IRS review to ensure that plans comply with tax law requirements for retirement plans. In general, the IRS reviews the plan design reflected in the plan documents. For plans which meet the tax law requirements for retirement plans, determination letters, which are a statement of the IRS' determination that a plan meets the qualification requirements of the Code, are issued to the requesting plan sponsors.[108]

The examination program involves the IRS' examination of plans to determine whether the qualification requirements are met in operation. The qualified plan examination program reviews issues of plan design as well as those arising in plan operation. For example, a plan that, by its terms, provides for contributions in a manner satisfying tax law requirements may in operation result in contribution levels that impermissibly favor highly compensated employees.

Additionally, the IRS has established EPCRS, which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), 408(k), or 408(p), as applicable.[109] EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a two-year period, without payment of any fee or sanction. The Voluntary Correction Program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Description of Proposal

Under the proposal, a plan will not be a disqualified if the plan makes good faith efforts to meet the requirements for qualification, has inadvertently failed to satisfy one or more of such requirements and either (1) substantially corrects (to the extent possible) such failure before the date the plan becomes subject to a plan examination for the applicable year (as determined under rules prescribed by the Secretary of the Treasury), or (2) substantially corrects (to the extent possible) such failure on or after such date. If the plan substantially corrects the failure on or after the date the plan is subject to examination for the applicable year, the Secretary may require the sponsoring employer to make a payment to the Secretary in an amount that does not exceed an amount that bears a reasonable relationship to the severity of the plan's failure to satisfy the

[108] Plan sponsors can also obtain from the IRS letter rulings on issues other than the qualified status of a retirement plan and the status of a tax-sheltered annuity.

[109] Rev. Proc. 2003-44, 2003-25 I.R.B. 1051.

requirements for qualification. The proposal provides similar rules for tax-sheltered annuities and plans with cash or deferred arrangements.

Effective Date

The proposal is effective on the date of enactment.

G. Fair Treatment Under Substantially Equal Periodic Payments Rule

Present Law

Present law imposes a 10-percent additional tax on withdrawals prior to age 59-1/2, death, or disability from tax-qualified retirement plans, tax-sheltered annuities (sec. 403(b)) and individual retirement arrangements.[110] There are a number of exceptions to this additional tax. Under one such exception, the early withdrawal tax does not apply to distributions that are part of a series of substantially equal periodic payments (not less frequently than annually) made for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and his or her designated beneficiary. A recapture tax is imposed if this exception applies to a distribution and the series of payments are modified (other than due to death or disability, or in certain other limited circumstances) either: (1) before the end of the five-year period beginning with the date of the first payment and after the employee attains age 59-1/2, (2) or before the employee attains age 59-1/2. The recapture tax is the amount, determined under regulations, which would have been imposed had the exception to the early withdrawal tax not applied, plus interest.

Description of Proposal

The proposal provides that if payments that satisfy the periodic payment exception to the early withdrawal tax are being made from a plan, a transfer or a rollover is made from the plan to another plan, and distributions from the transferor and transferee plans would satisfy the exception if made from the transferor plan, then the transfer or rollover will not be treated as being a modification of the periodic payments. Whether the distributions satisfy the periodic payment exception is determined on the basis of the combined distributions from the transferor and transferee plans.

The proposal provides that any reasonable interest rate may be used in determining whether payments are substantially equal under the exception.

Effective Date

The proposal with respect to transfers and rollovers is effective for transfers and rollovers after the date of enactment. The proposal relating to the interest rate is effective with respect to any series of payments beginning on or after the date of enactment.

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[110] Sec. 72(t).

H. Treatment of Annuity Contracts under Lump-Sum Distribution Rules

Present Law

Under present law, a plan participant who receives a lump-sum distribution from a tax-qualified retirement plan may elect to exclude from income the net unrealized appreciation on any employer securities received as part of the lump-sum distribution. In general, net unrealized appreciation is the excess of the market value of the employer securities at the time of the distribution over the basis of such securities to the plan. If a participant elects to exclude net unrealized appreciation on employer securities at the time of distribution, such amount is treated as long-term capital gain upon a subsequent disposition of the securities. Any amount received upon such disposition in excess of the net unrealized appreciation is subject to taxation under the normally applicable rules relating to taxation of capital gains.

In general, a lump-sum distribution means the payment within one taxable year of the balance of the credit to the employee which becomes payable to the recipient on account of the employee's death, after the employee attains age 59-1/2, on account of the employee's separation from service, or after the employee has become disabled.

Prior to the Small Business Job Protection Act of 1996, lump-sum distributions were also eligible for other special tax treatment in addition to the treatment of net unrealized appreciation on employer securities. Prior to that Act, the same definition of lump-sum distributions applied for purposes of the rule for net unrealized appreciation and the other rules for lump-sum distributions. That definition was generally the same as the present-law definition, except that it also provided that a distribution of an annuity contract constituted a lump-sum distribution.

Description of Proposal

The proposal clarifies that a distribution of an annuity contract from a tax-qualified retirement plan may be treated as part of a lump-sum distribution. Thus, any employer securities received in a lump-sum distribution that includes an annuity contract would be eligible for the exclusion of net unrealized appreciation on such securities.

Effective Date

The proposal is effective as if included in the Small Business Job Protection Act of 1996.

I. Allow Certain Plan Transfers and Mergers

Present Law

In general

A plan of deferred compensation that meets the qualification standards of the Code ("a qualified retirement plan") is accorded special tax treatment under present law. Employees do not include qualified retirement plan benefits in gross income until the benefits are distributed, even though the plan is funded and the benefits are nonforfeitable. The employer is entitled to a current deduction (within limits) for contributions to a qualified retirement plan even though the contributions are not currently included in an employee's income. Contributions to a qualified retirement plan are held in a tax-exempt trust.

Qualified retirement plans are broadly classified into two categories, defined benefit plans and defined contributions plans, based on the nature of the benefits provided. Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. Profit-sharing plans and qualified cash or deferred arrangements (commonly called "401(k) plans" after the section of the Internal Revenue Code regulating such plans) are examples of defined contribution plans.

Tax-sheltered annuities[111]

Tax-sheltered annuities are another form of employer-based retirement arrangement that provide tax benefits similar to qualified retirement plans. Tax-sheltered annuities may be maintained only by certain types of organizations, in particular, tax-exempt charitable organizations and educational institutions. Employers may contribute to such annuities on behalf of their employees, and employees may contribute on a pre-tax basis through salary reduction.

Tax-sheltered annuities are subject to some of the rules applicable to qualified retirement plans.[112] However, some of the rules applicable to tax-sheltered annuities are different, including (1) certain rules relating to vesting of employer contributions; (2) nondiscrimination rules applicable to certain employee contributions; (3) rules relating to providing benefits to married participants in the form of qualified joint and survivor annuities ("QJSAs"); (4)

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[111] Sec. 403(b).

[112] Tax-sheltered annuities are generally subject to ERISA, including the fiduciary rules of ERISA. Although some rules that apply to qualified retirement plans under the Code do not apply to tax-sheltered annuities, similar rules may apply under ERISA. However, certain section tax-sheltered annuities that provide only for salary reduction contributions are not considered established or maintained by an employer for purposes of ERISA and thus are not subject to ERISA. DOL Reg. sec. 2510.3-2(f).

prohibited reductions in accrued benefits; and (5) certain restrictions on distributions during employment.[113]

Merger and consolidations of plans or transfers of plan assets

Present law permits employers to merge or consolidate certain qualified retirement plans and transfer assets or liabilities from certain plans to other plans if specified requirements are satisfied. In such cases, no amount is includible in the income of the affected plan participants as a result of the merger, consolidation, or transfer. There are restrictions, however, on the types of plans which can be merged or consolidated or be involved in a transfer of assets or liabilities, as well as on how such transfer, mergers, and consolidations may be accomplished.[114] Transfers, mergers, and consolidations from a qualified retirement plan to a plan which is not qualified are generally not permitted under present law.

In general, in the case of any merger or consolidation of the plan with another plan or any transfer of assets or liabilities among plans, if each participant would receive a benefit immediately after the event which is equal to or greater than the benefit the individual would have been entitled to receive immediately before the event, the plan will not fail to meet applicable Code requirements.[115] For these purposes, each participant must receive benefits on a termination basis[116] from the plan immediately after the merger, consolidation or transfer which are equal to or greater than the benefits the participation would receive on a termination basis immediately before the merger, consolidation, or transfer.[117]

In the case of a merger of two or more defined contribution plans,[118] each participant is considered to receive a benefit immediately after the merger which is equal to or greater than the

[113] Sec. 403(b)(7)(A)(ii).

[114] Participants generally can make rollover contributions from qualified retirement plans, tax-sheltered annuities, and governmental section 457 plans to any of such plans or arrangements. Similarly, distributions from an individual retirement arrangement or annuity generally are permitted to be rolled over into a qualified retirement plan, tax-sheltered annuity, or governmental section 457 plan. In such cases, the rollover contribution is made at the election of the participant and is treated as a distribution, e.g., spousal consent requirements apply.

[115] Secs. 401(a)(12) and 414(l). Section 208 of ERISA provides similar rules for ERISA-covered plans.

[116] Benefits on a termination basis are the benefits that would be provided exclusively by the plan assets under ERISA section 4044. Treas. Reg. sec. 1.414(l)-1(b)(5).

[117] Treas. Reg. sec. 1.414(l)-2(ii).

[118] Special rules apply to mergers of two or more defined benefit plans. *See, e.g.,* Treas. Reg. sec. 1.414(l)-1(e)(1). In the case of a merger of a defined benefit and defined contribution plan, one of the plans must be converted into the other type of plan before the merger. Then, as appropriate, either the rules for the merger of defined contribution plans are applied or the rules for the merger of defined benefit plans are applied. Treas. Reg. sec. 1.414(l)-1(l).

benefit the individual would have been entitled to receive immediately before the event if three conditions are met: (1) the sum of the account balances in each plan is equal to the fair market value of the assets of the plan, (2) the assets of each plan are combined to form the assets of the resulting plan, and (3) immediately after the merger, each participant in the resulting plan has an account balance equal to the participant's balance in the merging plan (or, if an individual participates in more than one of the merging plans, the sum of all of the individual's account balances).[119]

Present law does not contain rules under which amounts (other than eligible rollover distributions by participants) can be merged, consolidated, or transferred between a tax-sheltered annuity and a qualified retirement plan on a nontaxable basis nor does it provide rules under which a tax-sheltered annuity can be amended to become a qualified retirement plan (or vice versa) without the loss of tax-favored status or income inclusion by the participants.[120]

Spousal protections[121]

In certain circumstances, a defined contribution plan is required to provide benefits in the form of a QJSA unless the participant and his or her spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. In plans subject to the survivor annuity rules, the surviving spouse of a participant who dies before the commencement of retirement benefits generally must be provided with a qualified preretirement survivor annuity ("QPSA"), which must provide the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

A defined contribution plan is required to provide benefits in the form of a QJSA if a participant elects an annuity as the form of payment, the surviving spouse is the participant's beneficiary (unless the spouse consents to the designation of another beneficiary), and, with respect to the participant, the plan has not received a transfer from a plan to which the QJSA and QPSA requirements applied (or separately accounts for the transferred assets).[122]

The participant and his or her spouse may waive the right to a QJSA (or QPSA, if applicable) provided certain requirements are satisfied.

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[119] Treas. Reg. sec. 1.414(l)-1(d).

[120] Mergers, consolidations, or transfers between tax-sheltered annuities and a qualified retirement plan have generally been held to cause participants' benefits to be includible in income as a taxable distribution. *See, e.g.,* Priv. Ltr. Rul. 200317022 (Sept. 24, 2002).

[121] Secs. 401(a)(11) and 417. Section 205 of ERISA provides similar rules for ERISA-covered plans.

[122] Defined benefit plans generally are required to provide benefits in the form of a QJSA unless the participant and his or her spouse consent to another form of benefit.

In case of a transfer, merger, or consolidation of plans, if the survivor annuity requirements apply to the plan from which benefits are transferred, but do not otherwise apply to the receiving plan, the survivor annuity requirements must be met with respect to the transferred benefits under the receiving plan.[123]

Prohibition on reductions in accrued benefits

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued.[124] In general, an amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, certain notice requirements are met.

For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

Under applicable Treasury regulations, the anticutback rule applies to transfers, mergers, and consolidations of plans.[125] Under the regulations, the transfer, merger, or consolidation of plans does not violate the anticutback rule if certain requirements are met.

Description of Proposal

The proposal provides that if a transfer or merger does not reduce the vested benefit or total benefit (including any non-vested benefit) of any participant or beneficiary, no amount will be includible in gross income by reason of (1) a transfer of all or a portion of a participant's account under a qualified defined contribution plan to a tax-sheltered annuity maintained by the same employer; (2) a transfer of all or a portion of a participant's account under a tax-sheltered annuity to a qualified defined contribution plan maintained by the same employer; or (3) a merger of a qualified defined contribution plan with a tax-sheltered annuity maintained by the same employer. Under the proposal, such a transfer or merger does not cause the plan or annuity to fail to meet the applicable Code requirements.

Additionally, under the proposal, amounts (and any income or loss attributable thereto) transferred or merged which are subject to spousal protections or the anticutback rule before the transfer or merger continue to be subject to those rules after the transfer or merger and are subject to the distribution requirements applicable to the transferee or merged plan.

[123] Treas. Reg. sec. 1.411(d)-4, Q&A 3(b)(2).

[124] Sec. 411(d)(6). Section 204(g) of ERISA provides similar rules for ERISA-covered plans.

[125] Treas. Reg. sec. 1.411(d)-4, Q&A 3.

Under the proposal, to the extent amounts transferred or merged are otherwise entitled to grandfather treatment under the transferor or predecessor plan, such amounts (and any income or loss attributable thereto) remain entitled to such treatment under the transferee or merged plan. For these purposes, grandfather treatment means special treatment under the Code or ERISA that is provided for prior benefits, prior periods of time, or certain individuals in connection with a change in applicable law.

The proposal also provides that in the case of a defined contribution plan or tax-sheltered annuity with respect to which transfers may be made only with the consent of a participant under the terms of the plan, contract, or applicable law, a transfer from such plan or contract may be made only if the participant consents to the transfer. For this purpose, a merger of a tax-sheltered annuity with a defined contribution plan will be treated as a transfer from the predecessor plan or contract to the merged plan or contract. The proposal does not affect the application of contract or plan terms otherwise applicable in the case of a withdrawal from the contract or plan.

Additionally, ERISA will apply to any plan or contract which is the subject of a transfer or merger under the proposal only to the extent necessary to comply with the requirements for such transfers and mergers.

The Secretary of the Treasury is directed to issue regulations implementing the proposal within one year after the date of enactment.

Effective Date

The proposal is effective for transfers and mergers in years beginning after the Secretary of the Treasury issues regulations as specified in the proposal.

J. Treatment of the Young Men's Christian Association Retirement Plans

<u>Present Law</u>

Favored tax treatment applies to an annuity contract purchased for an employee by an employer that is a tax-exempt charitable organization or an educational institution (a "tax-sheltered annuity").[126] For this purpose, a "retirement income account" is treated as an annuity contract.[127] A retirement income account means a defined contribution program established or maintained by a church or a convention or association of churches, including a church-controlled or church-associated organization whose principal purpose or function is the administration or funding of a retirement or welfare benefit plan or program for church employees.

Tax-sheltered annuity contracts must be purchased under a plan that meets certain nondiscrimination requirements.[128] The nondiscrimination requirements do not apply to an annuity contract purchased by a church; a convention or association of churches; an elementary or secondary school controlled, operated or principally supported by a church or a convention or association of churches; or certain church-controlled tax-exempt organizations.

Minimum distribution rules apply to tax-favored retirement arrangements, including tax-sheltered annuities.[129] Special minimum distribution rules apply to payments from an annuity contract purchased with an employee's benefit by a plan from an insurance company.[130] Annuity payments from a retirement income account may be eligible for these special minimum distribution rules even though the payments are not made under an annuity contract purchased from an insurance company.[131]

Under present law, certain types of organizations are eligible for tax-exempt status only if no substantial part of their activities consists of providing commercial-type insurance.[132] This requirement does not apply to the retirement fund of the YMCA.[133]

[126] Sec. 403(b).

[127] Sec. 403(b)(9)(B).

[128] Secs. 403(b)(1)(D) and 403(b)(12).

[129] Secs. 401(a)(9) and 403(b)(10).

[130] Treas. Reg. sec. 1.401(a)(9)-6T, A-4.

[131] Treas. Reg. sec. 1.403(b)-3, A-1(c)(3).

[132] Sec. 501(m).

[133] Sec. 1012(c)(4)(C)(i) of the Tax Reform Act of 1986.

Description of Proposal

Under the proposal, the retirement plans of the retirement fund of the YMCA (including the reserve accounts for such plans) are deemed to be retirement income accounts. The fund and plans are subject to the nondiscrimination requirements applicable to tax-sheltered annuities and are not treated as a contract purchased by a church for purposes of exemption from those nondiscrimination requirements. In addition, nothing in the proposal exempts the retirement fund of the YMCA from complying with the rules otherwise applicable to retirement income accounts in order for tax-favored treatment to apply.

Effective Date

The proposal is effective for years beginning after December 31, 2003.

VI. OTHER TAX PROVISIONS RELATING TO PENSIONS

A. Pension Plan Reporting Simplification

Present Law

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return.[134] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

The Form 5500 series consists of 2 different forms: Form 5500 and Form 5500-EZ. Form 5500 is the more comprehensive of the forms and requires the most detailed financial information. A plan administrator generally may file Form 5500-EZ, which consists of only one page, if (1) the only participants in the plan are the sole owner of a business that maintains the plan (and such owner's spouse), or partners in a partnership that maintains the plan (and such partners' spouses), (2) the plan is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b), (3) the employer is not a member of a related group of employers, and (4) the employer does not receive the services of leased employees. If the plan satisfies the eligibility requirements for Form 5500-EZ and the total value of the plan assets as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed $100,000, the plan administrator is not required to file a return.

With respect to a plan that does not satisfy the eligibility requirements for Form 5500-EZ, the characteristics and the size of the plan determine the amount of detailed financial information that the plan administrator must provide on Form 5500. If the plan has more than 100 participants at the beginning of the plan year, the plan administrator generally must provide more information.

Description of Proposal

The Secretary of the Treasury and the Secretary of Labor are directed to modify the annual return filing requirements with respect to plans that satisfy the eligibility requirements for Form 5500-EZ (referred to as a "one-participant retirement plan") to provide that if the total value of the plan assets of such a plan as of the end of the plan year does not exceed $250,000, the plan administrator is not required to file a return. In addition, the proposal directs the

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[134] Treas. Reg. sec. 301.6058-1(a).

Secretary of the Treasury and the Secretary of Labor to provide simplified reporting requirements for plan years beginning after December 31, 2004, for certain plans with fewer than 25 employees.

Effective Date

The proposal relating to one-participant retirement plans is effective for plan years beginning on or after January 1, 2003. The proposal relating to simplified reporting for plans with fewer than 25 employees is effective on the date of enactment.

B. Improvement of Employee Plans Compliance Resolution System

Present Law

A retirement plan that is intended to be a tax-qualified plan provides retirement benefits on a tax-favored basis if the plan satisfies all of the requirements of section 401(a). Similarly, an annuity that is intended to be a tax-sheltered annuity provides retirement benefits on a tax-favored basis if the program satisfies all of the requirements of section 403(b). Failure to satisfy all of the applicable requirements of section 401(a) or section 403(b) may disqualify a plan or annuity for the intended tax-favored treatment.

The Internal Revenue Service ("IRS") has established the Employee Plans Compliance Resolution System ("EPCRS"), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), section 403(b), section 408(k), or section 408(p) as applicable.[135] EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The IRS has designed EPCRS to (1) encourage operational and formal compliance, (2) promote voluntary and timely correction of compliance failures, (3) provide sanctions for compliance failures identified on audit that are reasonable in light of the nature, extent, and severity of the violation, (4) provide consistent and uniform administration of the correction programs, and (5) permit employers to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their retirement plans and annuities.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

The IRS has expressed its intent that EPCRS will be updated and improved periodically in light of experience and comments from those who use it.

Description of Proposal

The Secretary of the Treasury is directed to continue to update and improve EPCRS (or any successor program), giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction

[135] Rev. Proc. 2003-44, 2003-25 I.R.B. 1051.

of compliance failures, (3) extending the duration of the self-correction period under SCP for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under SCP during audit, and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

The proposal clarifies that the Secretary has the full authority to effectuate the foregoing with respect to EPCRS (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise or other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure.

Effective Date

The proposal is effective on the date of enactment.

C. Extension to all Governmental Plans of Moratorium on Application of Certain Nondiscrimination Rules Applicable to State and Local Government Plans

Present Law

A qualified retirement plan maintained by a State or local government is exempt from the requirements concerning nondiscrimination (sec. 401(a)(4)) and minimum participation (sec. 401(a)(26)). A qualified retirement plan maintained by a State or local government is also treated as meeting the participation and nondiscrimination requirements applicable to a qualified cash or deferred arrangement (sec. 401(k)(3)). Other governmental plans are subject to these requirements.[136]

Description of Proposal

The proposal exempts all governmental plans (as defined in sec. 414(d)) from the nondiscrimination and minimum participation rules. The proposal also treats all governmental plans as meeting the participation and nondiscrimination requirements applicable to a qualified cash or deferred arrangement.

Effective Date

The proposal is effective for years beginning after December 31, 2003.

[136] The IRS has announced that governmental plans that are subject to the nondiscrimination requirements are deemed to satisfy such requirements pending the issuance of final regulations addressing this issue. Notice 2003-6, 2003-3 I.R.B. 298; Notice 2001-46, 2001-2 C.B. 122.

D. Notice and Consent Period Regarding Distributions

Present Law

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements (sec. 417) apply to the participant.

If the present value of the participant's vested accrued benefit exceeds $5,000,[137] the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right, if any, to have the distribution directly transferred to another retirement plan or individual retirement arrangement ("IRA"), and (3) the rules concerning the taxation of a distribution. If the joint and survivor annuity requirements apply to the participant, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

If the participant's vested accrued benefit does not exceed $5,000, the terms of the plan may provide for distribution without the participant's consent. In that case, the plan must provide that, if the amount of the distribution exceeds $1,000, the plan administrator will transfer the distribution to a designated IRA unless the participant elects to receive the distribution directly or have it directly transferred to another retirement plan or IRA. Before making a distribution, the plan administrator generally is required to provide to the participant a notice that contains a written explanation of (1) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, (2) the fact that a distribution that exceeds $1,000 will be transferred to a designated IRA unless the participant elects otherwise, and (3) the rules concerning the taxation of a distribution. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

[137] The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested accrued benefit.

Description of Proposal

Under the proposal, a qualified retirement plan is required to provide the applicable distribution notice no less than 30 days and no more than 180 days before the date distribution commences. The Secretary of the Treasury is directed to modify the applicable regulations to reflect the extension of the notice period to 180 days and to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

Effective Date

The proposal and the modifications required to be made under the proposal apply to years beginning after December 31, 2003. In the case of a description of the consequences of a participant's failure to defer receipt of a distribution that is made before the date 90 days after the date on which the Secretary of the Treasury makes modifications to the applicable regulations, the plan administrator is required to make a reasonable attempt to comply with the requirements of the proposal.

E. Reduced PBGC Premiums for Small and New Plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay benefits promised under the plan. The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. The amount of the required annual PBGC premium for a single-employer plan is generally a flat rate premium of $19 per participant and an additional variable-rate premium based on a charge of $9 per $1,000 of unfunded vested benefits. Unfunded vested benefits under a plan generally means (1) the unfunded current liability for vested benefits under the plan, over (2) the value of the plan's assets, reduced by any credit balance in the funding standard account. No variable-rate premium is imposed for a year if contributions to the plan were at least equal to the full funding limit.

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than five years, and with respect to benefit increases from a plan amendment that was in effect for less than five years before termination of the plan.

Description of Proposal

Reduced flat-rate premiums for new plans of small employers

Under the proposal, for the first five plan years of a new single-employer plan of a small employer, the flat-rate PBGC premium is $5 per plan participant.

A small employer would be a contributing sponsor that, on the first day of the plan year, has 100 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are to be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributes, employees of all contributing sponsors (and their controlled group members) are to be taken into account in determining whether the plan was a plan of a small employer.

A new plan means a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as in the new plan.

Reduced variable-rate PBGC premium for new plans

The proposal provides that the variable-rate premium is phased in for new defined benefit plans over a six-year period starting with the plan's first plan year. The amount of the variable-rate premium is a percentage of the variable premium otherwise due, as follows: zero percent of the otherwise applicable variable-rate premium in the first plan year; 20 percent in the second plan year; 40 percent in the third plan year; 60 percent in the fourth plan year; 80 percent in the fifth plan year; and 100 percent in the sixth plan year (and thereafter).

A new defined benefit plan is defined as described above under the flat-rate premium provision of the proposal relating to new small employer plans.

Reduced variable-rate PBGC premium for small plans

In the case of a plan of a small employer, the variable-rate premium is no more than $5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For purposes of the proposal, a small employer is a contributing sponsor that, on the first day of the plan year, has 25 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are to be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributed, employees of all contributing sponsors (and their controlled group members) are to be taken into account in determining whether the plan was a plan of a small employer.

Effective Date

The reduction of the flat-rate premium for new plans of small employers and the reduction of the variable-rate premium for new plans apply to plans first effective after December 31, 2003. The reduction of the variable-rate premium for small plans applies to plan years beginning after December 31, 2003.

F. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds

Present Law

The PBGC charges interest on underpayments of premiums, but is not authorized to pay interest on overpayments.

Description of Proposal

The proposal allows the PBGC to pay interest on overpayments made by premium payors. Interest paid on overpayments is to be calculated at the same rate and in the same manner as interest charged on premium underpayments.

Effective Date

The proposal is effective with respect to interest accruing for periods beginning not earlier than the date of enactment.

G. Rules for Substantial Owner Benefits in Terminated Plans

Present Law

Under present law, the Pension Benefit Guaranty Corporation ("PBGC") provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees as to the receipt of benefits under the plan in case of plan termination. The employer sponsoring the defined benefit pension plan is required to pay premiums to the PBGC to provide insurance for the guaranteed benefits. In general, the PBGC will guarantee all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. The amount of the guaranteed benefit is subject to certain limitations. One limitation is that the plan (or an amendment to the plan which increases benefits) must be in effect for 60 months before termination for the PBGC to guarantee the full amount of basic benefits for a plan participant, other than a substantial owner. In the case of a substantial owner, the guaranteed basic benefit is phased in over 30 years beginning with participation in the plan. A substantial owner is one who owns, directly or indirectly, more than 10 percent of the voting stock of a corporation or all the stock of a corporation. Special rules restricting the amount of benefit guaranteed and the allocation of assets also apply to substantial owners.

Description of Proposal

The proposal provides that the 60-month phase-in of guaranteed benefits applies to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest ("majority owner"), the phase-in occurs over a 10-year period and depends on the number of years the plan has been in effect. The majority owner's guaranteed benefit is limited so that it cannot be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets apply to substantial owners, other than majority owners, in the same manner as other participants.

Effective Date

The proposal is effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC, after December 31, 2003.

VII. STOCK OPTIONS

A. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options from Wages

Present Law

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[138]

If the statutory holding period requirements are satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option.

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes (collectively referred to as "employment taxes") are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[139] The applicable Code provisions[140] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option.

There has been uncertainty in the past as to employer withholding obligations upon the exercise of statutory stock options. On June 25, 2002, the IRS announced that until further guidance is issued, it would not assess FICA or FUTA taxes, or impose Federal income tax withholding obligations, upon either the exercise of a statutory stock option or the disposition of stock acquired pursuant to the exercise of a statutory stock option.[141]

Description of Proposal

The proposal provides specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, under the proposal,

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[138] Sec. 421. For purposes of the individual alternative minimum tax, the transfer of stock pursuant to an incentive stock option is generally treated as the transfer of stock pursuant to a nonstatutory option. Sec. 56(b)(3).

[139] Secs. 3101, 3111 and 3301.

[140] Secs. 3121 and 3306.

[141] Notice 2002-47, 2002-28 I.R.B. 1.

FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[142] The proposal also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the proposal provides that Federal income tax withholding is not required on a disqualifying disposition, nor when compensation is recognized in connection with an employee stock purchase plan discount. Present law reporting requirements continue to apply.

Effective Date

The proposal is effective for stock acquired pursuant to options exercised after the date of enactment.

[142] The proposal also provides a similar exclusion under the Railroad Retirement Tax Act.

VIII. MISCELLANEOUS PROVISIONS

A. Provisions Relating to Plan Amendments

Present Law

Present law provides a remedial amendment period during which, under certain circumstances, a plan may be amended retroactively in order to comply with the qualification requirements.[143] In general, plan amendments to reflect changes in the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs. The Secretary of the Treasury may extend the time by which plan amendments need to be made.

Description of Proposal

The provision permits certain plan amendments made pursuant to the changes made by the bill or by title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001[144] ("EGTRRA") (or regulations issued thereunder) to be retroactively effective. If the plan amendment meets the requirements of the provision, then the plan will be treated as being operated in accordance with its terms and the amendment will not violate the prohibition of reductions of accrued benefits. In order for this treatment to apply, the plan amendment is required to be made on or before the last day of the first plan year beginning on or after January 1, 2006 (January 1, 2008, in the case of a governmental plan). If the amendment is required to be made to retain qualified status as a result of the changes in the law (or regulations), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the changes made by the bill or EGTRRA (or applicable regulations) may be made retroactively effective as of the first day the plan is operated in accordance with the amendment.

A plan amendment will not be considered to be pursuant to the bill or EGTRRA (or applicable regulations) if it has an effective date before the effective date of the provision of the bill or EGTRRA (or regulations) to which it relates. Similarly, the provision does not provide relief from section 411(d)(6) for periods prior to the effective date of the relevant provision (or regulations) or the plan amendment.

The Secretary is authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It is intended that the Secretary will not permit inappropriate reductions in contributions or benefits that are not directly related to the provisions of the bill or EGTRRA. For example, it is intended that a plan that incorporates the section 415 limits by reference can be retroactively amended to impose the section 415 limits in effect before

[143] Sec. 401(b).

[144] Pub. L. No. 107-16. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

EGTTRA.[145] On the other hand, suppose a plan incorporates the section 401(a)(17) limit on compensation by reference and provides for an employer contribution of three percent of compensation. It is expected that the Secretary will provide that, in that case, the plan cannot be amended retroactively to reduce the contribution percentage for those participants not affected by the section 401(a)(17) limit, even though the reduction will result in the same dollar level of contributions for some participants because of the increase in compensation taken into account under the plan as a result of the increase in the section 401(a)(17) limit under EGTRRA. As another example, suppose that under present law a plan is top-heavy and therefore a minimum benefit is required under the plan, and that under the provisions of EGTRRA, the plan is not considered to be top-heavy. It is expected that the Secretary will generally permit plans to be retroactively amended to reflect the new top-heavy provisions of EGTRRA.

Effective Date

The provision is effective on the date of enactment.

[145] See also, section 411(j)(3) of the Job Creation and Worker Assistance Act of 2002, which provides a special rule for plan amendments adopted on or before June 30, 2002, in connection with EGTRRA, in the case of a plan that incorporated the section 415 limits by reference on June 7, 2001, the date of enactment of EGTRRA.

B. Application of EGTRRA Sunset

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the Federal tax laws, including a variety of provisions relating to pensions and individual retirement arrangements ("IRAs"). In order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a "sunset" provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted.

Certain provisions contained in EGTRRA expire before the general sunset date of 2010.

Description of Proposal

The proposal clarifies that the EGTRRA sunset continues to apply to any of the provisions of the proposal that modify a provision subject to the sunset.

Effective Date

The proposal is effective on the date of enactment.