DESCRIPTION OF THE SENATE FINANCE COMMITTEE CHAIRMAN'S MARK OF THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT"

Scheduled for Markup
By the
SENATE COMMITTEE ON FINANCE
on September 17, 2003

Prepared by the Staff
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JOINT COMMITTEE ON TAXATION

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CONTENTS

INTRODUCTION

The Senate Committee on Finance has scheduled a markup on September 17, 2003, of the "National Employee Savings and Trust Equity Guarantee Act." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark of the "National Employee Savings and Trust Equity Guarantee Act."

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Senate Finance Committee Chairman's Mark of the "National Employee Savings and Trust Equity Guarantee Act"* (JCX-77-03), September 15, 2003.

I. DIVERSIFICATION OF PENSION PLAN ASSETS

A. Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets

Present Law

In general

Defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a "section 401(k) plan"), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions.

Under the Internal Revenue Code (the "Code"),[2] elective deferrals, after-tax employee contributions, and employer matching contributions are subject to special nondiscrimination tests. Certain employer nonelective contributions may be used to satisfy these special nondiscrimination tests. In addition, plans may satisfy the special nondiscrimination tests by meeting certain safe harbor contribution requirements.

The Code requires employee stock ownership plans ("ESOPs") to offer certain plan participants the right to diversify investments in employer securities. The Employee Retirement Income Security Act of 1974 ("ERISA") limits the amount of employer securities and employer real property that can be acquired or held by certain employer-sponsored retirement plans. The extent to which the ERISA limits apply depends on the type of plan and the type of contribution involved.

Diversification requirements applicable to ESOPs under the Code

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer and that meets certain other requirements under the Code. An ESOP can be an entire plan or it can be a component of a larger defined contribution plan. An ESOP may provide for different types of contributions. For example, an ESOP may include a qualified cash or deferred arrangement that permits employees to make elective deferrals.[3]

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[2] All references to the "Code" are to the Internal Revenue Code. All section references and descriptions of present law refer to the Code unless otherwise indicated.

[3] Such an ESOP design is sometimes referred to as a "KSOP."

Under the Code, ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.[4] The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if (1) the plan distributes the applicable amount to the participant within 90 days after the election period, (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election, or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[5]

ERISA limits on investments in employer securities and real property

ERISA imposes restrictions on the investment of retirement plan assets in employer securities or employer real property.[6] A retirement plan may hold only a "qualifying" employer security and only "qualifying" employer real property.

Under ERISA, any stock issued by the employer or an affiliate of the employer is a qualifying employer security.[7] Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). Qualifying employer real property means parcels of employer real property: (1) if a substantial number of the parcels are dispersed geographically; (2) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use; (3) even if all of the real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and (4) if the acquisition and retention of such property generally comply with the fiduciary rules of ERISA (with certain specified exceptions).

ERISA also prohibits defined benefit plans and money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities or

[4] Sec. 401(a)(28). The present-law diversification requirements do not apply to employer securities held by an ESOP that were acquired before January 1, 1987.

[5] IRS Notice 88-56, 1988-1 C.B. 540, Q&A-16.

[6] ERISA sec. 407.

[7] Certain additional requirements apply to employer stock held by a defined benefit plan or a money purchase pension plan (other than certain plans in existence before the enactment of ERISA).

employer real property if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities and real property. Except as discussed below with respect to elective deferrals, this 10-percent limitation generally does not apply to defined contribution plans other than money purchase pension plans.[8] In addition, a fiduciary generally is deemed not to violate the requirement that plan assets be diversified with respect to the acquisition or holding of employer securities or real property in a defined contribution plan.[9]

The 10-percent limitation on the acquisition of employer securities and real property applies separately to the portion of a plan consisting of elective deferrals (and earnings thereon) if any portion of an individual's elective deferrals (or earnings thereon) are required to be invested in employer securities or real property pursuant to plan terms or the direction of a person other than the participant. This restriction does not apply if (1) the amount of elective deferrals required to be invested in employer securities and real property does not exceed more than one percent of any employee's compensation, (2) the fair market value of all defined contribution plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer, or (3) the plan is an ESOP.

Description of Proposal

In general

Under the proposal, in order to satisfy the plan qualification requirements of the Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities or employer real property. Such a plan is required to permit applicable individuals to direct that the portion of the individual's account held in employer securities or employer real property be invested in alternative investments. Under the proposal, an applicable individual includes (1) any plan participant and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant. The time when the diversification requirements apply depends on the type of contributions invested in employer securities or employer real property.

Plans subject to requirements

The diversification requirements generally apply to an "applicable defined contribution plan,"[10] which means a defined contribution plan holding publicly-traded employer securities

[8] The 10-percent limitation also applies to a defined contribution plan that is part of an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

[9] Under ERISA, a defined contribution plan is generally referred to as an individual account plan. Plans that are not subject to the 10-percent limitation on the acquisition of employer securities are referred to as "eligible individual account plans."

[10] Under ERISA, the diversification requirements apply to an "applicable individual account plan."

(i.e., securities issued by the employer or a member of the employer's controlled group of corporations[11] that are readily tradable on an established securities market).

For this purpose, a plan holding employer securities that are not publicly traded is generally treated as holding publicly-traded employer securities if the employer (or any member of the employer's controlled group of corporations) has issued a class of stock that is a publicly-traded employer security. This treatment does not apply if neither the employer nor any parent corporation[12] of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to any member of the employer's controlled group that has issued any publicly-traded employer security. For example, a controlled group that generally consists of corporations that have not issued publicly-traded securities, may include a member that has issued publicly-traded stock (the "publicly-traded member"). In the case of a plan maintained by an employer that is another member of the controlled group, the diversification requirements do not apply to the plan, provided that neither the employer nor a parent corporation of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or issuer with respect to the member that has issued publicly-traded stock. The Secretary of the Treasury has the authority to provide other exceptions in regulations. For example, an exception may be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer's controlled group has issued a small amount of publicly-traded stock.

The diversification requirements do not apply to an ESOP that: (1) does not hold contributions (or earnings thereon) that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions; and (2) is a separate plan from any other qualified retirement plan of the employer. Accordingly, an ESOP that holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests (including the safe harbor methods of satisfying the tests) is subject to the diversification requirements under the proposal. The diversification rights applicable under the proposal are broader than those applicable under the Code's present-law ESOP diversification rules. Thus, an ESOP that is subject to the new requirements is excepted from the present-law rules.[13]

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[11] For this purpose, "controlled group of corporations" has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

[12] For this purpose, "parent corporation" has the same meaning as under section 424(e), i.e., any corporation (other than the employer) in an unbroken chain of corporations ending with the employer if each corporation other than the employer owns stock possessing at least 50 percent of the total combined voting power of all classes of stock with voting rights or at least 50 percent of the total value of shares of all classes of stock in one of the other corporations in the chain.

[13] An ESOP will not be treated as failing to be designed to invest primarily in qualifying employer securities merely because the plan provides diversification rights as required under the proposal or greater diversification rights than required under the proposal.

The diversification requirements under the proposal also do not apply to a one-participant retirement plan. A one-participant retirement plan is a plan that: (1) on the first day of the plan year, covers only one individual (or the individual and his or her spouse) and the individual owns 100 percent of the plan sponsor (i.e., the employer maintaining the plan), whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; (2) meets the minimum coverage requirements without being combined with any other plan that covers employees of the business; (3) does not provide benefits to anyone except the individuals (and spouses) described in (1), (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control; and (5) does not cover a business that uses leased employees. It is intended that, for this purpose, a "partner" includes an owner of a business that is treated as a partnership for tax purposes. In addition, it includes a two-percent shareholder of an S corporation.[14]

Elective deferrals and after-tax employee contributions

In the case of amounts attributable to elective deferrals under a qualified cash or deferred arrangement and employee after-tax contributions that are invested in employer securities or employer real property, any applicable individual must be permitted to direct that such amounts be invested in alternative investments.

Other contributions

In the case of amounts attributable to contributions other than elective deferrals and after-tax employees contributions (i.e., nonelective employer contributions and employer matching contributions) that are invested in employer securities or employer real property, an applicable individual who is a participant with three years of service,[15] a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in alternative investments.

The proposal provides a transition rule for amounts attributable to these other contributions that are invested in employer securities or employer real property acquired before the first plan year for which diversification requirements apply. Under the transition rule, for the first three years for which the new diversification requirements apply to the plan, the applicable percentage of such amounts is subject to diversification as shown in Table 1, below. The applicable percentage applies separately to each class of employer security and to employer real property in an applicable individual's account. The transition rule does not apply to plan participants who have three years of service and who have attained age 55 by the beginning of the first plan year beginning after December 31, 2003.

[14] Under section 1372, a two-percent shareholder of an S corporation is treated as a partner for fringe benefit purposes.

[15] Years of service is defined as under the rules relating to vesting (sec. 411(a)).

Table 1 – Applicable Percentage for Employer Securities or Employer Real Property Held on Effective Date

Plan year for which diversification applies:	**Applicable percentage:**
First year	33 percent
Second year	66 percent
Third year	100 percent

Requirements for investment alternatives

A plan subject to the diversification requirements is required to give applicable individuals a choice of at least three investment options, other than employer securities or employer real property, each of which is diversified and has materially different risk and return characteristics. It is intended that other investment options generally offered by the plan also must be available to applicable individuals.

A plan does not fail to meet the diversification requirements merely because the plan limits the times when divestment and reinvestment can be made to periodic, reasonable opportunities that occur at least quarterly. It is intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities or employer real property on the same basis as the opportunity to make other investment changes, except in unusual circumstances. Thus, in general, applicable individuals must be given the opportunity to request changes with respect to investments in employer securities or employer real property with the same frequency as the opportunity to make other investment changes and that such changes are implemented in the same timeframe as other investment changes, unless circumstances require different treatment.

Except as provided in regulations, a plan may not impose restrictions or conditions with respect to the investment of employer securities or employer real property that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of the application of securities laws). For example, such a restriction or condition includes a provision under which a participant who divests his or her account of employer securities or employer real property receives less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities or employer real property. On the other hand, such a restriction does not include the imposition of fees with respect to other investment options under the plan, merely because fees are not imposed with respect to investments in employer securities.

Effective Date

The proposal is generally effective for plan years beginning after December 31, 2003. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal is effective for plan years beginning after the earlier of (1) the later of December 31, 2004, or the date on which the last of such collective bargaining agreements terminates

(determined without regard to any extension thereof after the date of enactment), or
(2) December 31, 2005.

B. Notice of Freedom to Divest Employer Securities or Real Property

Present Law

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan. This information includes, for example, a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan. Under ERISA, if a plan administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

The Code contains a variety of notice requirements with respect to qualified plans. Such requirements are generally enforced by an excise tax. For example, in case of a failure to provide notice of a significant reduction in benefit accruals, an excise tax of $100 is generally imposed on the employer. If the employer exercised reasonable diligence in meeting the requirements, the excise tax with respect to a taxable year is limited to no more than $500,000.

Description of Proposal

In general

The proposal requires a new notice under the Code and ERISA in connection with the right of an applicable individual to divest his or her account under an applicable defined contribution plan of employer securities or employer real property, as required under the diversification proposal of the bill. Not later than 30 days before the first date on which an applicable individual is eligible to exercise such right, the administrator of the plan must provide the individual with a notice setting forth such right and describing the importance of diversifying the investment of retirement account assets.

The Secretary of Labor is directed to prescribe a model notice to be used for this purpose. The notice must be in a form calculated to be understood by the average plan participant. The notice may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the applicable individual.

Sanctions for failure to provide information

Excise tax

Under the proposal, an excise tax generally applies in the case of a failure to provide notice of diversification rights as required under the Code. The excise tax is generally imposed on the employer if notice is not provided.[16] The excise tax is $100 per day for each participant or

[16] In the case of a multiemployer plan, the excise tax is imposed on the plan.

beneficiary with respect to whom the failure occurs, until notice is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year will not exceed $500,000.

No tax will be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the notice requirement. In addition, no tax will be imposed if the employer exercises reasonable diligence to comply and provides the required notice within 30 days of learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

ERISA civil penalty

In the case of a failure to provide notice of diversification rights as required under ERISA, the Secretary of Labor may assess a civil penalty against the plan administrator of up to $100 a day from the date of the failure. For this purpose, each violation with respect to any single applicable individual is treated as a separate violation.

Effective Date

The proposal applies on the date of enactment of the proposal.

II. INFORMATION TO ASSIST PENSION PLAN PARTICIPANTS

A. Periodic Pension Benefit Statements and Investment Education

Present Law

In general

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan.[17] If a plan administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

The Code contains a variety of notice requirements with respect to qualified plans. Such requirements are generally enforced by an excise tax. For example, in case of a failure to provide notice of a significant reduction in benefit accruals, an excise tax of $100 is generally imposed on the employer. If the employer exercised reasonable diligence in meeting the requirements, the excise tax with respect to a taxable year is limited to no more than $500,000.

Pension benefit statements

ERISA provides that a plan administrator must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. This requirement applies in the case of any plan that is subject to ERISA. This requirement applies to both individual account plans[18] and defined benefit plans. The benefit statement must indicate, on the basis of the latest available information: (1) the participant's or beneficiary's total accrued benefit; and (2) the participant's or beneficiary's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than one benefit statement during any 12-month period.

Statements to participants on separation from service

A plan administrator must furnish a statement to each participant who: (1) separates from service during the year; (2) is entitled to a deferred vested benefit under the plan as of the end of the plan year; and (3) whose benefits were not paid during the year. The statement must set forth the nature, amount, and form of the deferred vested benefit to which the participant is entitled. The plan administrator generally must provide the statement no later than 180 days after the end of the plan year in which the separation from service occurs.

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[17] Governmental plans and church plans are exempt from ERISA, including requirements to provide notices or information to participants.

[18] An "individual account plan" is the term generally used under ERISA for a defined contribution plan.

Investment guidelines

Present law does not require that participants be given investment guidelines relating to retirement savings.

Description of Proposal

Pension benefit statements

In general

The proposal provides new benefit statement requirements under the Code and ERISA, depending in part on the type of plan and the individual to whom the statement is provided.

Requirements for defined contribution plans and tax-deferred annuities

In the case of a defined contribution plan (other than a one-participant retirement plan)[19] or a tax-deferred annuity, the plan administrator is required under the Code and ERISA to provide a benefit statement (1) to a participant or beneficiary who has the right to direct the investment of the assets in his or her account, at least quarterly, (2) to any other participant or other beneficiary who has his or her own account under the plan, at least annually, and (3) to other beneficiaries, upon written request, but limited to one request during any 12-month period.

The benefit statement is required to indicate, on the basis of the latest available information: (1) the total benefits accrued; (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested; and (3) an explanation of any offset that may be applied in determining accrued benefits under a plan that provides for permitted disparity or that is part of a floor-offset arrangement (i.e., an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under a defined contribution plan). With respect to information on vested benefits, the Secretary of Labor is required to provide that the requirements of the proposal are met if, at least annually, the plan: (1) updates the information on vested benefits that is provided in the benefit statement; or (2) provides in a separate statement information as is necessary to enable participants and beneficiaries to determine their vested benefits.

The benefit statement must also include: (1) the value of each investment to which assets in the individual's account are allocated (determined as of the plan's most recent valuation date), including the value of any assets held in the form or employer securities or employer real property (without regard to whether the securities or real property were contributed by the employer or acquired at the direction of the individual); and (2) a notice that investments in any individual account may not be adequately diversified if the value of any investment in the account exceeds 20 percent of the fair market value of all investments in the account. A quarterly statement provided to a participant or beneficiary who has the right to direct the

[19] The term "one-participant retirement plan" is defined as under the proposal requiring plans to provide diversification rights with respect to employer securities and employer real property.

investment of the assets in his or her account must also include an explanation of any limitations or restrictions on the right of the individual to direct an investment.

Requirements for defined benefit plans

Under the proposal, the administrator of a defined benefit plan is generally required under the Code and ERISA either: (1) to furnish a benefit statement at least once every three years to each participant who has a vested accrued benefit and who is employed by the employer at the time the benefit statements are furnished to participants; or (2) to furnish at least annually to each such participant notice of the availability of a benefit statement and the manner in which the participant can obtain it. The Secretary of Labor is authorized to provide that years in which no employee or former employee benefits under the plan need not be taken into account in determining the three-year period. It is intended that the annual notice of the availability of a benefit statement may be included with other communications to the participant if done in a manner reasonably designed to attract the attention of the participant.

The administrator of a defined benefit plan is also required to furnish a benefit statement to a participant or beneficiary upon written request, limited to one request during any 12-month period.

The benefit statement is required to indicate, on the basis of the latest available information: (1) the total benefits accrued; (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested; and (3) an explanation of any offset that may be applied in determining accrued benefits under a plan that provides for permitted disparity or that is part of a floor-offset arrangement (i.e., an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under a defined contribution plan). With respect to information on vested benefits, the Secretary of Labor is required to provide that the requirements of the proposal are met if, at least annually, the plan: (1) updates the information on vested benefits that is provided in the benefit statement; or provides in a separate statement information as is necessary to enable participants and beneficiaries to determine their vested benefits. In the case of a statement provided to a participant (other than at the participant's request), information may be based on reasonable estimates determined under regulations prescribed by the Secretary of Labor in consultation with the Pension Benefit Guaranty Corporation.

Form of benefit statement

The benefit statement must be written in a manner calculated to be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the recipient. For example, regulations could permit current benefit statements to be provided on a continuous basis through a secure plan website for a participant or beneficiary who has access to the website.

The Secretary of Labor is directed, within 180 days after the date of enactment of the proposal, to develop one or more model benefit statements, written in a manner calculated to be understood by the average plan participant, that may be used by plan administrators in complying with the requirements of ERISA and the Code. The use of the model statement is optional. It is intended that the model statement include items such as the amount of nonforfeitable accrued benefits as of the statement date that are payable at normal retirement age under the plan, the amount of accrued benefits that are forfeitable but that may become nonforfeitable under the terms of the plan, information on how to contact the Social Security Administration to obtain a participant's personal earnings and benefit estimate statement, and other information that may be important to understanding benefits earned under the plan.

Investment guidelines

In general

Under the proposal, the plan administrator of a defined contribution plan (other than a one-participant retirement plan) or a tax-deferred annuity is required under the Code and ERISA to provide at least once a year a model form relating to basic investment guidelines to each participant or beneficiary who has the right to direct the investment of the assets in his or her account under the plan.

Model form

Under the proposal, the Secretary of the Treasury is directed, in consultation with the Secretary of Labor, to develop and make available a model form containing basic guidelines for investing for retirement. The guidelines in the model form are to include: (1) information on the benefits of diversification of investments; (2) information on the essential differences, in terms of risk and return, of pension plan investments, including stocks, bonds, mutual funds and money market investments; (3) information on how an individual's investment allocations under the plan may differ depending on the individual's age and years to retirement, as well as other factors determined by the Secretary; (4) sources of information where individuals may learn more about pension rights, individual investing, and investment advice; and (5) such other information related to individual investing as the Secretary determines appropriate.

The model form must also include addresses for Internet sites, and a worksheet, that a participant or beneficiary may use to calculate: (1) the retirement age annuity value of the individual's vested benefits under the plan (determined by reference to varied historical annual rates of return and annuity interest rates); and (2) other important amounts relating to retirement savings, including the amount that an individual must save in order to provide a retirement income equal to various percentages of his or her current salary (adjusted for expected growth prior to retirement). The Secretary of the Treasury is directed to provide at least 90 days for public comment before publishing final notice of the model form and to update the model form at least annually. In addition, the Secretary of Labor is required to develop an Internet site to be used by an individual in making these calculations, the address of which will be included in the model form.

The model form must be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the recipient.

Sanctions for failure to provide information

Excise tax

Under the proposal, an excise tax generally applies in the case of a failure to provide a benefit statement or an investment guideline model form as required under the Code. The excise tax is generally imposed on the employer if a required benefit statement or model form is not provided.[20] The excise tax is $100 per day for each participant or beneficiary with respect to whom the failure occurs, until the benefit statement or model form is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the benefit statement or model form requirement, the total excise tax imposed during a taxable year will not exceed $500,000. The $500,000 annual limit will apply separately to failures to provide required benefit statements and failures to provide the model form.

No tax will be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the benefit statement or model form requirement. In addition, no tax will be imposed if the employer exercises reasonable diligence to comply and provides the required benefit statement or model form within 30 days of learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

ERISA enforcement

The ERISA remedies that apply in the case of a failure or refusal to provide a participant with information under present law apply if the plan administrator fails or refuses to furnish a benefit statement required under the proposal. That is, the participant or beneficiary is entitled to bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or such other relief that the court deems proper.

In the case of a failure to provide a model form relating to basic investment guidelines required under the proposal, the Secretary of Labor may assess a civil penalty against the plan administrator of up to $100 a day from the date of the failure. For this purpose, each violation with respect to any single participant or beneficiary is treated as a separate violation.

Exception for governmental and church plans

The proposal contains an exception from the benefit statement and investment notice requirements under the Code for a governmental plan or a church plan. In addition, such plans are generally exempt from ERISA. Accordingly, the benefit statement and investment notice requirements do not apply to a governmental plan or a church plan.

[20] In the case of a multiemployer plan, the excise tax is imposed on the plan. In the case of a tax-sheltered annuity (sec. 403(b)) that is not a plan established or maintained by the employer, the tax is imposed on the plan administrator.

Effective Date

The proposal is generally effective for plan years beginning after December 31, 2004. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal is effective for plan years beginning after the earlier of (1) the later of December 31, 2005, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2006.

B. Material Information Relating to Investment in Employer Securities

Present Law

The Code and ERISA require that certain information be provided to participants and beneficiaries under employer-sponsored retirement plans. Present law does not specifically require that participants in defined contribution plans which permit participants to direct the investment of the assets in their accounts in employer securities be provided with the reports, statements, and communications which are required to be provided to investors in connection with investing in securities under applicable securities laws.

The Code contains a variety of notice requirements with respect to qualified plans. Such requirements are generally enforced by an excise tax. For example, in case of a failure to provide notice of a significant reduction in benefit accruals, an excise tax of $100 is generally imposed on the employer. If the employer exercised reasonable diligence in meeting the requirements, the excise tax with respect to a taxable year is limited to no more than $500,000.

Under ERISA, if a plan administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.

Description of Proposal

In general

The proposal creates a new requirement in connection with defined contribution plans which permit participants to direct the investment of the assets in their accounts in employer securities. The proposal amends the Code and ERISA to require administrators of such plans to provide participants with all reports, proxy statements, and other communications regarding investment of such assets in employer securities to the extent that such reports, statements, and communications are required to be provided by the plan sponsor to investors in connection with investment employer securities under applicable securities laws. Any such information which is maintained by the plan sponsor must be provided to the plan administrator.

The reports, statements, and communications may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to participants.

Sanctions for failure to provide information

<u>Excise tax</u>

Under the proposal, an excise tax generally applies in the case of a failure to provide the information as required under the Code. The excise tax is generally imposed on the employer if notice is not provided.[21] The excise tax is $100 per day for each participant or beneficiary with respect to whom the failure occurs, until notice is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year will not exceed $500,000.

No tax will be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the notice requirement. In addition, no tax is imposed if the employer exercises reasonable diligence to comply and provides the required notice within 30 days of learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

ERISA civil penalty

In the case of a failure or refusal to provide the information as required under the proposal, the Secretary of Labor may assess a civil penalty against the plan administrator of up to $1,000 a day from the date of the failure or refusal until it is corrected.

Exception for governmental and church plans

The proposal contains an exception under the Code for a governmental plan or a church plan. In addition, such plans are generally exempt from ERISA. Accordingly, the proposal does not apply to a governmental plan or a church plan.

Effective Date

The proposal is generally effective for plan years beginning after December 31, 2003. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal is effective for plan years beginning after the earlier of (1) the later of December 31, 2004, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2005.

[21] In the case of a multiemployer plan, the excise tax is imposed on the plan. In the case of a section 403(b) annuity that is not established or maintained by the employer, the excise tax is imposed on the plan administrator.

III. PROTECTION OF PENSION PLAN PARTICIPANTS

A. Notice to Participants or Beneficiaries of Blackout Periods

Present Law

In general

The Sarbanes-Oxley Act of 2002[22] amended ERISA to require that the plan administrator of an individual account plan[23] provide advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.[24] Generally, notice must be provided at least 30 days before the beginning of the blackout period. In the case of a blackout period that applies with respect to employer securities, the plan administrator must also provide timely notice of the blackout period to the employer (or the affiliate of the employer that issued the securities, if applicable).

The blackout notice requirement does not apply to a one-participant retirement plan, which is defined as a plan that (1) on the first day of the plan year, covered only the employer (and the employer's spouse) and the employer owns the entire business (whether or not incorporated) or covers only one or more partners (and their spouses) in a business partnership (including partners in an S or C corporation as defined in section 1361(a) of the Code), (2) meets the minimum coverage requirements without being combined with any other plan that covers employees of the business, (3) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses), (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control, and (5) does not cover a business that leases employees.[25]

Definition of blackout period

A blackout period is any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of

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[22] Pub. L. No. 107-204, enacted July 30, 2002.

[23] An "individual account plan" is the term generally used under ERISA for a defined contribution plan.

[24] ERISA sec. 101(i), as enacted by section 306(b) of the Sarbanes-Oxley Act of 2002. Under section 306(a), a director or executive officer of a publicly-traded corporation is prohibited from trading in employer stock during blackout periods in certain circumstances. Section 306 is effective 180 days after enactment.

[25] Governmental plans and church plans are exempt from ERISA. Accordingly, the blackout notice requirement does not apply to these plans.

more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary under a qualified domestic relations order.

Timing of notice

Notice of a blackout period is generally required at least 30 days before the beginning of the period. The 30-day notice requirement does not apply if (1) deferral of the blackout period would violate the fiduciary duty requirements of ERISA and a plan fiduciary so determines in writing, or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator and a plan fiduciary so determines in writing. In those cases, notice must be provided as soon as reasonably practicable under the circumstances unless notice in advance of the termination of the blackout period is impracticable.

Another exception to the 30-day period applies in the case of a blackout period that applies only to one or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or the employer and that occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of the merger, acquisition, divestiture, or similar transaction. Under the exception, the blackout notice requirement is treated as met if notice is provided to the participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

The Secretary of Labor may provide additional exceptions to the notice requirement that the Secretary determines are in the interests of participants and beneficiaries.

Form and content of notice

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

Notices provided in connection with a blackout period (or changes thereto) must be provided in writing and may be delivered in electronic or other form to the extent that the form is reasonably accessible to the recipient. The Secretary of Labor is required to issue guidance regarding the notice requirement and a model blackout notice.

Penalty for failure to provide notice

In the case of a failure to provide notice of a blackout period, the Secretary of Labor may assess a civil penalty against a plan administrator of up to $100 per day for each failure to provide a blackout notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

Code requirements

The Code does not contain a notice requirement with respect to blackouts. However, the Code contains a variety of other notice requirements with respect to qualified plans. Such requirements are generally enforced by an excise tax. For example, in case of a failure to provide notice of a significant reduction in benefit accruals, an excise tax of $100 is generally imposed on the employer. If the employer exercised reasonable diligence in meeting the requirements, the excise tax with respect to a taxable year is limited to no more than $500,000.

Description of Proposal

In general

The proposal amends the Code to include the blackout notice requirement added to ERISA by the Sarbanes-Oxley Act of 2002 and makes certain modifications to the notice requirement.

Definition of blackout period

The proposal also revises the definition of blackout period under the Code and ERISA. The definition of blackout period is revised to include a suspension, limitation, or restriction of any ability of participants or beneficiaries to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, that is otherwise available under the plan, without regard to whether the ability is specifically provided for in the terms of the plan.

Definition of one-participant plan

The proposal revises the definition of a one-participant retirement plan not subject to the blackout notice requirement. Under the proposal, for purposes of the blackout notice requirements under the Code and ERISA, the definition is conformed to the definition that applies under the proposal relating to diversification, thus clarifying that such a plan covers only an individual (or the individual and his or her spouse) who owns 100 percent of the plan sponsor (i.e., the employer maintaining the plan), whether or not incorporated, or covers only one or more partners (or partners and their spouses) in the plan sponsor. For this purpose, a partner includes an owner of a business that is treated as a partnership for tax purposes and a two-percent shareholder of an S corporation.

Excise tax for failure to provide notice

Under the proposal, an excise tax generally applies in the case of a failure to provide a blackout notice as required under the Code. A reporting penalty applies in the case of a failure related to a governmental plan or a church plan.

Under the proposal, an excise tax is generally imposed on the employer if a blackout notice is not provided.[26] The excise tax is $100 per day for each applicable individual with respect to whom the failure occurred, until notice is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the notice requirements, the total excise tax imposed during a taxable year will not exceed $500,000. No tax will be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the notice requirement. In addition, no tax will be imposed if the employer exercises reasonable diligence to comply and provides the required notice as soon as reasonably practicable after learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

Exception for governmental and church plans

The proposal contains an exception under the Code for a governmental plan or a church plan. In addition, such plans are generally exempt from ERISA. Accordingly, the proposal does not apply to a governmental plan or a church plan.

Effective Date

The amendments to the Code apply to failures to provide the required notice after the date of enactment. The amendments to ERISA made by the proposal are effective as if included in section 306 of the Sarbanes-Oxley Act of 2002.

[26] In the case of a multiemployer plan, the excise tax is imposed on the plan. In the case of a tax-sheltered annuity program under section 403(b) that is not treated as established or maintained by the employer for purposes of ERISA, the excise tax is imposed on the plan administrator.

B. Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participant or Beneficiary to Direct Investments

Present Law

Fiduciary rules under ERISA

ERISA contains general fiduciary duty standards that apply to all fiduciary actions, including investment decisions. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. With respect to plan assets, ERISA requires a fiduciary to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so. Certain individual account plans[27] are not subject to the diversification requirement for investments or the general prudence requirement (to the extent that it requires diversification) with respect to investments in employer stock.

A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. A plan fiduciary may be liable also for a breach of responsibility by another fiduciary (a "co-fiduciary") in certain circumstances.

Special rule for participant control of assets

ERISA provides a special rule for an individual account plan that permits participants to exercise control over the assets in their individual accounts. Under the special rule, if a participant exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's exercise of control.

Regulations issued by the Department of Labor describe the requirements that must be met in order for a participant to be treated as exercising control over the assets in his or her account. With respect to investment options, the regulations provide in part:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option (the general volatility rule);

[27] An "individual account plan" is the term generally used under ERISA for a defined contribution plan.

- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);
- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer stock to ensure that employees' buying, selling, and voting decisions are confidential and free from employer influence.

If these and the other requirements under the regulations are met, a plan fiduciary may be liable for the investment options made available under the plan, but not for the specific investment decisions made by participants.

Description of Proposal

Under the proposal, relief from fiduciary liability for any loss or breach resulting from a participant's exercise of control over assets generally does not apply in the case of a blackout period during which the ability of the participant to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary. For this purpose, a blackout period is defined as under the ERISA provision requiring advance notice of a blackout period.[28] Under a special rule, if a blackout period occurs in connection with a change in the investment options offered under the plan, a participant is deemed to have exercised control over the assets in his or her account before the blackout period if, after notice of the change in investment options is given to the participant, assets in the account of the participant are transferred either (1) to investment options in accordance with the participant's affirmative election (provided that the election otherwise meets the conditions for the participant to exercise control over the assets in the account), or (2) in the absence of an affirmative election by the participant and where fiduciary relief applied with respect to the prior investment options, to investment options in the manner set forth in the notice.

In addition, under the proposal, if the fiduciary meets the requirements of ERISA in connection with authorizing the blackout period, the fiduciary will not be liable for any loss occurring during the blackout period as a result of a participant's or beneficiary's exercise of control over assets in his or her account before the blackout period. Matters to be considered in determining whether the requirements of ERISA were satisfied include (but are not limited to) whether the fiduciary (1) considered the reasonableness of the expected blackout period, (2) provided the required notice of the blackout period, and (3) acted in accordance with the general fiduciary duty standards of ERISA in determining whether to enter into the blackout period. The Secretary of Labor is required, in consultation with the Secretary of the Treasury, to issue, before January 1, 2004, interim final regulations providing guidance, including safe harbors, on how plan fiduciaries will be able to satisfy their fiduciary responsibilities during a

[28] ERISA sec. 101(i).

blackout period during which the ability of a participant or beneficiary to direct the investment of the assets in his or her account is suspended.

Effective Date

The proposal is effective for plan years beginning after December 31, 2003. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal applies to plan years beginning after the earlier of (1) the later of December 31, 2004, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2005.

C. Liability for Breach of Fiduciary Duty

Present Law

ERISA contains general fiduciary duty standards that apply to all fiduciary actions. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. Under a general fiduciary liability provision of ERISA, a plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets.[29] In addition, the fiduciary is subject to other equitable or remedial relief as a court deems appropriate, including the removal of the fiduciary.

A plan participant, beneficiary, or fiduciary, or the Secretary of Labor, may bring a civil action for appropriate relief under the general fiduciary liability provision of ERISA.[30] This general fiduciary liability provision has been interpreted to provide broad relief (including money damages) and to authorize the award of damages to make the plan whole for investment losses due to a breach of fiduciary duty. However, amounts recovered under the general fiduciary liability provision are not payable to a participant personally, even in the case of a civil action brought by a participant, because such recovery must be on behalf of the plan.[31] In the case of a recovery with respect to an individual account plan,[32] amounts recovered generally are payable to the plan and allocated to participants' accounts.[33] Issues have arisen under present law regarding the extent to which damages recovered under the general fiduciary liability provision with respect to a breach of fiduciary liability affecting a participant's account under an individual account plan are to be allocated to the participant's account.[34]

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[29] ERISA sec. 409.

[30] ERISA sec. 502(a)(2).

[31] *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134 (1985).

[32] An "individual account plan" is the term generally used under ERISA for a defined contribution plan.

[33] Funds held under an individual account plan must be allocated to participants' accounts in accordance with a definite formula. The plan must provide for the valuation of amounts held by the plan, and allocations and adjustments of participants' accounts in accordance with the valuation, at least once a year. *See* Rev. Rul. 80-155, 1980-1 C.B. 84.

[34] Under ERISA sec. 502(a)(2), a participant may bring a civil action to obtain appropriate equitable relief to redress any violations of ERISA, or to enforce any provisions of ERISA or the terms of the plan, including recovery for a breach of fiduciary duty. However, "appropriate equitable relief" that a participant may obtain on his or her own behalf does not

Description of Proposal

Insider liability for breach of fiduciary duty

The proposal applies the general fiduciary liability provision of ERISA to an insider of the employer who, with respect to a plan that holds employer securities that are readily tradable on an established securities market, knowingly participates in, or knowingly undertakes to conceal, an act or omission of fiduciary responsibility, knowing the act or omission is a breach of fiduciary responsibility. Under the proposal, the insider is personally liable to the plan or any plan participant or beneficiary for the breach of fiduciary duty in the same manner as the fiduciary that commits the breach.

Under the proposal, an "insider" is defined by reference to regulations under the Federal securities laws[35] (as in effect on the date of enactment of the provision) and means the employer's president, principal financial officer, principal accounting officer (or, if none, the controller), any vice-president of the employer in charge of a principal business unit, division, or function (such as sales, administration, or finance), any officer who performs a policy-making function, or any other person who performs similar policy-making functions for the employer. For these purposes, officers of a parent or subsidiary of the employer who perform policy-making functions for the employer and, when the employer is limited partnership, officers or employees of the general partner who perform policy-making functions for the limited partnership are deemed to be officers of the employer. When the employer is a trust, officers or employees of the trustee who perform policy-making functions for the trust are deemed officers of the trust. An "insider" also includes a director of the employer.

Recovery in the case of an individual account plan

The proposal revises the general fiduciary liability provision of ERISA to address relief provided in the case of a breach of fiduciary duty involving an individual account plan. Under the proposal, any relief provided in that case is, to the extent the court may deem appropriate, to inure to the account of any individual affected by the breach (or directly to the individual in the absence of an individual account). The proposal is not to be construed to give rise to any inference of the existence or nonexistence of rights under any provision of ERISA, including the general fiduciary liability provision or the civil enforcement provisions of ERISA.

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include money damages (i.e., compensatory damages). *See Mertens v. Hewitt Associates*, 508 U.S. 248 (1993). Participants in individual account plans who have brought action against a plan fiduciary have been denied the recovery of damages for the difference between the earnings on their accounts and the amount of earnings they would have received if the plan administrator had complied with the participants' instructions as to the transfer or distribution of the accounts because lost earnings are considered compensatory damages. *See Helfrich v. PNC Bank, Kentucky, Inc.*, 267 F.3d 477 (6th Cir. 2001), *cert.den.*, reported at 2002 U.S. LEXIS 1558 (March 18, 2002); *Kerr v. Charles F. Vatterott & Co.*, 184 F.3d 938 (8th Cir. 1999).

[35] 17 CFR 240.16a-1(f).

Effective Date

The proposal generally applies with respect to breaches of fiduciary responsibility that occur on or after the date of enactment. The proposal relating to recovery in cases involving individual account plans applies to actions that are pending on, or commenced on or after, the date of enactment.

D. Increase in Maximum Bond Amount for Plans Holding Employer Securities

Present Law

ERISA generally requires every fiduciary and every person who handles funds or other property of a plan (a "plan official") to be bonded. The amount of the bond is fixed annually at no less than ten percent of the funds handled but must be at least $1,000 and not more than $500,000 (unless the Secretary of Labor prescribes a larger amount after notice and an opportunity to be heard). The bonds are intended to protect plans against loss from acts of fraud or dishonesty by plan officials. Qualifying bonds must have a corporate surety which is an acceptable surety on Federal bonds.

Description of Proposal

The proposal raises the maximum bond amount to $1 million for fiduciaries of plans that hold employer securities.

Effective Date

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

E. Provisions Relating to Whistleblower Actions Involving Pension Plans

Present Law

ERISA contains various safeguards that are designed to protect the rights of plan participants and beneficiaries. Under ERISA, it is unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against ("retaliate") a plan participant or beneficiary for exercising any rights under a plan, certain ERISA provisions, or the Welfare and Pension Plans Disclosure Act ("WPPDA"). ERISA also prohibits retaliation that is intended to interfere with the attainment of such rights or against persons who have provided information, testified, or are about to testify in an inquiry or proceeding under ERISA or the WPPDA. Participants, beneficiaries, and the Secretary of Labor may bring actions for violations of these prohibitions in Federal court.

Description of Proposal

Under the proposal, the prohibition on retaliation applies to persons who provide information, cause information to be provided, or otherwise assist in an investigation, inquiry, or proceeding regarding conduct which they reasonably believe violates ERISA or the WPPDA in connection with a plan ("whistleblowers"). Under the proposal, in order for the prohibition to apply, a whistleblower must provide the information or assistance to, or the investigation must be conducted by, a Federal regulatory or law enforcement agency, any Member of Congress or committee of Congress, or a person with supervisory authority over the whistleblower (or any other person working for the employer who has the authority to investigate, discover, or terminate misconduct).

The proposal also provides that ERISA's prohibition against retaliation applies to persons who (with any knowledge of the employer) file, cause to be filed, testify in, participate in, or otherwise assist in a proceeding filed in connection with an alleged violation of ERISA involving a plan.

The proposal confers standing on the Secretary of Labor and persons to whom the prohibition against retaliation applies (including whistleblowers) to bring suit in Federal court for violations of the prohibition in connection with a pension plan. Under the proposal, such persons may seek (1) to enjoin any act or practice that violates the prohibition or (2) payment of back pay (including benefits and interest), reinstatement with the same seniority status that the employee would have had if the violation had not occurred, or, if reinstatement is not practicable or cannot be ordered without delay, payment of such amounts (including benefits) as the court deems appropriate in lieu of reinstatement or earlier reinstatement, as well as attorney fees and costs. For this purpose, as under ERISA's current civil enforcement provisions, reasonable attorneys fees and costs are awardable at the discretion of the court.

Effective Date

The proposal is effective on the date of enactment.

F. Increase in Penalties for Coercive Interference with Exercise of ERISA Rights

Present Law

ERISA prohibits any person from using or attempting to use force or violence to restrain, coerce, or intimidate any plan participant or beneficiary in order to interfere with or prevent the exercise of their rights under ERISA or the Welfare and Pension Plans Disclosure Act ("WPPDA"). Willful violation of this prohibition is a criminal offense subject to a $10,000 fine or imprisonment of up to one year, or both.

Description of Proposal

The proposal amends ERISA by increasing the penalties for willful acts of coercive interference with participants' rights under ERISA or the WPPDA. The amount of the fine is raised to $100,000 and the maximum term of imprisonment is increased to ten years.

Effective Date

The proposal applies to violations occurring on or after the date of enactment.

IV. OTHER PROVISIONS RELATING TO PENSIONS

A. 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.[36] 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.

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

Description of Proposal

The proposal clarifies that the Secretary has the full authority to establish and implement 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.

Under the 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 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.

Effective Date

The proposal is effective on the date of enactment.

B. 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.[37]

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 plan years beginning after December 31, 2003.

[37] 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.

C. 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,[38] 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.

[38] 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.

D. Technical Corrections to the SAVER Act

Present Law

The Savings Are Vital to Everyone's Retirement ("SAVER") Act initiated a public-private partnership to educate American workers about retirement savings and directed the Department of Labor to maintain an ongoing program of public information and outreach. The Act also convened a National Summit on Retirement Savings held June 4-5, 1998. A second National Summit on Retirement Savings was held February 27 through March 1, 2002, co-hosted by the President and the bipartisan Congressional leadership. The National Summit brings together experts in the fields of employee benefits and retirement savings, key leaders of government, and interested parties from the private sector and general public. The delegates are selected by the Congressional leadership and the President. The National Summit is a public-private partnership, receiving substantial funding from private sector contributions. The goals of the National Summits are to: (1) advance the public's knowledge and understanding of retirement savings and facilitate the development of a broad-based, public education program; (2) identify the barriers which hinder workers from setting aside adequate savings for retirement and impede employers, especially small employers, from assisting their workers in accumulating retirement savings; and (3) develop specific recommendations for legislative, executive, and private sector actions to promote retirement income savings among American workers.

Description of Proposal

Under the proposal, future National Summits on Retirement Savings are to be held in 2006 and 2010.

Six new statutory delegates are added to future National Summits: the Chairman and Ranking Member of each of the following: the Senate Committee on Finance, the House Committee on Ways and Means, and the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce. The proposal also clarifies that new delegates are to be appointed for each future National Summit (as was the intent of the original legislation) and sets deadlines for their appointment.

The proposal also sets deadlines for the Department of Labor to publish the Summit agenda and gives the Department of Labor limited reception and representation authority.

Effective Date

The proposal is effective on the date of enactment.

E. Missing Participants

Present Law

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

If the plan administrator of a terminating single employer plan cannot locate a participant 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.[39]

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

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.

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 provision 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 is effective for distributions made after final regulations implementing the provision are prescribed.

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

F. 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.

G. 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.

H. 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.

I. Benefit Suspension Notice

Present Law

Under present law, a plan will not fail to satisfy the vesting requirements with respect to a participant by reason of suspending payment of the participant's benefits while such participant is employed.[40] Under the applicable Department of Labor ("DOL") regulations, such a suspension is only permissible if the plan notifies the participant during the first calendar month or payroll period in which the plan withholds benefit payments. Such notice must provide certain information and must also include a copy of the plan's provisions relating to the suspension of payments.

In the case of a plan that does not pay benefits to active participants upon attainment of normal retirement age, the employer must monitor plan participants to determine when any participant who is still employed attains normal retirement age. In order to suspend payment of such a participant's benefits, generally a plan must, as noted above, promptly provide the participant with a suspension notice.

Description of Proposal

Under the proposal, the Secretary of Labor is required to modify the regulations relating to the benefit suspension notice (1) to permit the information currently required to be set forth in a suspension notice generally to be included in the summary plan description, rather than in a separate notice, and (2) not to require that the notice include a copy of relevant plan provisions. However, individuals reentering the workforce to resume work with a former employer after having begun to receive benefits would still receive the notification of the suspension of benefits (and a copy of the plan's provisions relating to suspension of payments). Such notice is required to be provided during the first calendar month, or during the first four- or five-week payroll period ending in a calendar month, in which the plan withholds payments.

Effective Date

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

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[40] ERISA sec. 203(a)(3)(B).

J. Voluntary Early Retirement Incentive and Employment Retention Plans Maintained by Local Educational Agencies and Other Entities

Present Law

Eligible deferred compensation plans of State and local governments and tax-exempt employers

A "section 457 plan" is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. For example, the amount that can be deferred annually under section 457 cannot exceed a certain dollar limit ($12,000 for 2003). Amounts deferred under a section 457 plan are generally includible in gross income when paid or made available (or, in the case of governmental section 457 plans, when paid). Subject to certain exceptions, amounts deferred under a plan that does not comply with section 457 (an "ineligible plan") are includible in income when the amounts are not subject to a substantial risk of forfeiture. Section 457 does not apply to any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan. Additionally, section 457 does not apply to qualified retirement plans or qualified governmental excess benefit plans that provide benefits in excess of those that are provided under a qualified retirement plan maintained by the governmental employer.

ERISA

ERISA provides rules governing the operation of most employee benefit plans. The rules to which a plan is subject depend on whether the plan is an employee welfare benefit plan or an employee pension benefit plan. For example, employee pension benefit plans are subject to reporting and disclosure requirements, participation and vesting requirements, funding requirements, and fiduciary provisions. Employee welfare benefit plans are not subject to all of these requirements. Governmental plans are exempt from ERISA.

Age Discrimination in Employment Act

The Age Discrimination in Employment Act ("ADEA") generally prohibits discrimination in employment because of age. However, certain defined benefit plans may lawfully provide payments that constitute the subsidized portion of an early retirement benefit or social security supplements pursuant to ADEA[41], and employers may lawfully provide a voluntary early retirement incentive plan that is consistent with the purposes of ADEA.[42]

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[41] See ADEA sec. 4(l)(1).

[42] See ADEA sec. 4(f)(2).

Description of Proposal

Early retirement incentive plans of local educational agencies and education associations

The proposal addresses the treatment of certain voluntary early retirement incentive plans ("VERIPs") under section 457, ERISA, and ADEA.

Code section 457

Under the proposal, special rules apply under section 457 to a VERIP that is maintained by a local educational agency or a tax-exempt education association which principally represents employees of one or more such agencies and that makes payments or supplements as an early retirement benefit, a retirement-type subsidy, or a social security supplement in coordination with a defined benefit plan maintained by a State or local government or by such an association. Such a VERIP is treated as a bona fide severance plan for purposes of section 457, and therefore is not subject to the limits under section 457, to the extent the payments or supplements could otherwise be provided under the defined benefit plan. For purposes of the proposal, the payments or supplements that could otherwise be provided under the defined benefit plan are to be determined by applying the accrual and vesting rules for defined benefit plans.[43]

ERISA

In addition, such VERIPs are treated as a welfare benefit plan for purposes of ERISA (other than a governmental plan that is exempt from ERISA).

ADEA

The proposal also addresses the treatment under ADEA of VERIPs that are maintained by local educational agencies and tax-exempt education associations which principally represent employees of one or more such agencies, and that make payments or supplements that constitute the subsidized portion of an early retirement benefit or a social security supplement and that are made in coordination with a defined benefit plan maintained by a State or local government or by such an association. Under the proposal, for purposes of ADEA, such a plan is treated as part of the defined benefit plan and the payments or supplements under the plan are not severance pay that may be subject to certain deductions under ADEA.

Employment retention plans of local educational agencies and education associations

The proposal addresses the treatment of certain employment retention plans under section 457 and ERISA. The proposal applies to employment retention plans that are maintained by local educational agencies or tax-exempt education associations which principally represent employees of one or more such agencies and that provide compensation to an employee (payable

[43] The accrual and vesting rules have the effect of limiting the social security supplements and early retirement benefits that may be provided under a defined benefit plan; however, government plans are exempt from these rules.

on termination of employment) for purposes of retaining the services of the employee or rewarding the employee for service with educational agencies or associations.

Under the proposal, special tax treatment applies to the portion of an employment retention plan that provides benefits that do not exceed twice the applicable annual dollar limit on deferrals under section 457 ($12,000 for 2003). The proposal provides an exception from the rules under section 457 for ineligible plans with respect to such portion of an employment retention plan. This exception applies for years preceding the year in which benefits under the employment retention plan are paid or otherwise made available to the employee. In addition, such portion of an employment retention plan is not treated as providing for the deferral of compensation for tax purposes.

Under the proposal, an employment retention plan is also treated as a welfare benefit plan for purposes of ERISA (other than a governmental plan that is exempt from ERISA).

Effective Date

The proposal is generally effective on the date of enactment. The amendments to section 457 apply to taxable years ending after the date of enactment. The amendments to ERISA apply to plan years ending after the date of enactment. Nothing in the proposal alters or affects the construction of the Code, ERISA, or ADEA as applied to any plan, arrangement, or conduct to which the proposal does not apply.

K. Automatic Rollovers of Certain Involuntary Distributions

Present Law

In general

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. 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. Before making a distribution that is eligible for rollover, the 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.

IRS guidance on default rollovers

Under a 2000 ruling issued by the IRS,[44] a qualified retirement plan may provide that the default form of payment of an involuntary distribution is a direct rollover to an IRA, unless the participant elects (1) a direct rollover to another qualified retirement plan or IRA or (2) to receive the payment in cash. Under the plan described in the ruling, the plan administrator selected an IRA trustee, custodian or issuer, established the IRA on behalf of the participant, and made initial investment choices for the account.

The ruling noted that the Department of Labor had advised the Department of Treasury and the IRS that, in the context of a default direct rollover as described in the ruling, the participant ceases to be a participant covered under the plan within the meaning of ERISA and the distributed assets cease to be plan assets for purposes of ERISA if the distribution constituted the entire benefit rights of the participant. The ruling also noted that the Department of Labor had advised that the selection of an IRA trustee, custodian, or issuer and IRA investment for purposes of a default direct rollover would constitute a fiduciary act subject to the general fiduciary standards and prohibited transaction provisions of ERISA. In addition, the Department of Labor noted that plan provisions governing the default direct rollover of distributions, including the participant's ability to affirmatively opt out of the arrangement, must be described in the plan's summary plan description furnished to participants and beneficiaries.

Automatic rollover of involuntary distributions

Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"),[45] a direct rollover to an IRA must be automatic for an involuntary distribution that exceeds $1,000

[44] Rev. Rul. 2000-36, 2000-2 C.B. 140.

[45] Pub. L. No. 107-16.

and that is an eligible rollover distribution from a qualified retirement plan.[46] That is, the distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

ERISA fiduciary rules

ERISA contains general fiduciary duty standards that apply to all fiduciary actions related to employer-sponsored pension plans, including actions related to the investment of plan assets. However, these fiduciary rules generally do not apply to IRAs.

ERISA provides a special rule for an individual account plan that permits participants to exercise control over the assets in their individual accounts.[47] Under the special rule, if a participant exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's exercise of control.

In connection with the EGTRRA provisions relating to automatic direct rollovers, the ERISA provision dealing with fiduciary liability when a participant exercises control over the assets in his or her account was amended to provide that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon (1) the earlier of a rollover of all or a portion of the amount to another IRA, or one year after the automatic rollover is made, or (2) the making of an automatic rollover in a manner consistent with guidance provided by the Secretary of Labor.[48] EGTRRA directed the Secretary of Labor to prescribe regulations, not later than three years after the date of enactment of EGTRRA, providing safe harbors under which the designation of an institution and investment of funds in accordance with the automatic direct rollover provision are deemed to satisfy the general fiduciary duty requirements of ERISA.[49] The automatic rollover provisions apply to distributions made after the Department of Labor has adopted final regulations providing the required safe harbor. No such regulations have been adopted.

Description of Proposal

The proposal repeals the ERISA provision relating to when a participant is considered to exercise control over the assets in an IRA following an automatic rollover. The provision thus clarifies that amounts transferred from a qualified retirement plan to an IRA in an automatic

[46] Section 401(a)(31)(B) of the Code, as added by section 657 of EGTRRA.

[47] ERISA sec. 404(c).

[48] ERISA sec. 404(c)(3), as added by section 657 of EGTRRA. Section 411(t) of the Job Creation and Worker Assistance Act of 2002 made clerical corrections to the wording of this provision.

[49] ERISA sec. 404(a).

rollover are no longer plan assets for ERISA purposes, as indicated under the Department of Labor's position with respect to default direct rollovers before the enactment of EGTRRA.

In addition, the provision directs the Department of Labor, not later than December 31, 2003, to issue interim final regulations, or other administrative guidance, under which the designation of an institution and investment of funds in accordance with the automatic rollover provision are deemed to satisfy the general fiduciary duty requirements of ERISA.[50]

The Secretaries of the Treasury and Labor may provide, and are to give consideration to providing, special relief with respect to the use of low-cost individual retirement plans for purposes of the automatic rollover provision and for other uses that promote the preservation of assets for retirement income purposes.

Effective Date

The provisions are effective for distributions made after December 31, 2004.

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[50] Sec. 404(a) of ERISA.

L. Extension of Transition Rule to Pension Funding Requirements

Present Law

Under present law, defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required if a defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. Quarterly minimum funding contributions are required in the case of certain underfunded plans.

The Pension Benefit Guaranty Corporation ("PBGC") insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

Under present law, a special rule modifies the minimum funding requirements in the case of certain plans. The special rule applies in the case of plans that (1) were not required to pay a variable rate PBGC premium for the plan year beginning in 1996, (2) do not, in plan years beginning after 1995 and before 2009, merge with another plan (other than a plan sponsored by an employer that was a member of the controlled group of the employer in 1996), and (3) are sponsored by a company that is engaged primarily in interurban or interstate passenger bus service.

The special rule treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2005 if for such plan year the funded current liability percentage is at least 85 percent. If the funded current liability of the plan is less than 85 percent for any plan year beginning after 1996 and before 2005, the relief from the minimum funding requirements applies only if certain specified contributions are made.

For plan years beginning after 2004 and before 2010, the funded current liability percentage will be deemed to be at least 90 percent if the actual funded current liability percentage is at least at certain specified levels. The relief from the minimum funding requirements applies for a plan year beginning in 2005, 2006, 2007, or 2008 only if contributions to the plan for the plan year equal at least the expected increase in current liability due to benefits accruing during the plan year.

Description of Proposal

The proposal modifies the special funding rules for plans sponsored by a company engaged primarily in interurban or interstate passenger bus service by providing that, for plan years beginning in 2004 and 2005, the funded current liability percentage of the plan will be treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining the timing of plan contributions). In addition, for these years, the mortality table used under the plan will be used in determining the amount of unfunded vested benefits under the plan.

Effective Date

The proposal is effective with respect to plan years beginning after December 31, 2003.

M. Acceleration of PBGC Computation of Benefits Attributable to Recoveries from Employers

Present Law

In general

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 promised benefits.[51] The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. In general, the PBGC guarantees 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. For plans terminating in 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.

The PBGC pays plan benefits, subject to the guarantee limits, when it becomes trustee of a terminated plan. The PBGC also pays amounts in addition to the guarantee limits ("additional benefits") if there are sufficient plan assets, including amounts recovered from the employer for unfunded benefit liabilities and contributions owed to the plan. The employer (including members of its controlled group) is statutorily liable for these amounts.

Plan underfunding recoveries

The PBGC's recoveries on its claims for unfunded benefit liabilities are shared between the PBGC and plan participants. The amounts recovered are allocated partly to the PBGC to help cover its losses for paying unfunded guaranteed benefits and partly to participants to help cover the loss of benefits that are above the PBGC's guarantees and are not funded. In determining the portion of the recovered amounts that will be allocated to participants, present law specifies the use of an average recovery ratio, rather than the actual amount recovered for each specific plan. The average recovery ratio that applies to a plan includes the PBGC's actual recovery experience for plan terminations in the five-year period immediately preceding the year the particular plan is terminated.

The average recovery ratio is used for all but very large plans taken over by the PBGC. For a very large plan (i.e., a plan for which participants' benefit losses exceed $20 million) actual recovery amounts with respect to the specific plan are used to determine the portion of the amounts recovered that will be allocated to participants.

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[51] The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

Recoveries for due and unpaid employer contributions

Amounts recovered from an employer for contributions owed to the plan are treated as plan assets and are allocated to plan benefits in the same manner as other assets in the plan's trust on the plan termination date. The amounts recovered are determined on a plan-specific basis rather than based on an historical average recovery ratio.

Description of Proposal

The proposal makes two amendments to the PBGC insurance provisions of ERISA. First, it changes the five-year period used to determine the average recovery ratio for unfunded benefit liabilities by moving the period back two years. For example, the average recovery ratio for a plan terminating in 2003 is based on recovery experience for plan terminations in 1996-2000, rather than 1998-2002.

In addition, the proposal creates an average recovery ratio for determining amounts recovered for contributions owed to the plan, based on the PBGC's recovery experience over the same five-year period. Use of an average recovery ratio for this purpose makes it possible to determine the additional benefits attributable to these recoveries at the time the plan terminates.

The proposal does not apply to very large plans (i.e., plans for which participants' benefit losses exceed $20 million). As under present law, in the case of a very large plan, actual amounts recovered for unfunded benefit liabilities and for contributions owed to the plan are used to determine the amount available to provide additional benefits to participants.

Effective Date

The proposal is effective for any plan termination for which notices of intent to terminate are provided (or, in the case of a termination by the PBGC, a notice of determination that the plan must be terminated is issued) on or after the date that is 30 days after the date of enactment.

N. Multiemployer Plan Explanation Notice

Present Law

Pension plan funding

Under present law, defined benefit plans are generally required to meet certain minimum funding rules. An employer that is unable to make the contributions necessary to satisfy the minimum funding standards without temporary substantial business hardship (substantial business hardship in the case of multiemployer plans) for a particular year may apply to the IRS for a waiver of the minimum funding standard for the year.

The Pension Benefit Guaranty Corporation ("PBGC") provides insurance 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. In general, the PBGC guarantees 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. For 2003, the maximum guaranteed benefit for an individual retiring at age 65 is $3,664.77 per month, or $43,977.24 per year.

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. Accordingly, a multiemployer plan need not be terminated to qualify for PBGC financial assistance, but must be found to be insolvent. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year.

Information and reporting requirements under ERISA

A qualified retirement plan is subject to annual reporting requirements under both the Internal Revenue Code and ERISA. The plan administrator of a qualified retirement plan generally must submit an annual report of certain information with respect to the qualification, financial condition, and operation of the plan. This report is made as a single submission to the Department of Labor on the Form 5500, which forwards copies of the report to the IRS and the PBGC. The plan administrator must automatically provide participants with a summary of the annual report. In addition, on written request, a participant must be provided with a copy of the full annual report. A plan administrator is also required to furnish participants with other notices and information about the plan.

Description of Proposal

Annual funding notice

Under the proposal, the administrator of a multiemployer plan is required to provide participants with an annual funding notice. Such a notice will include: (1) identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan's principal administrative officer, the plan sponsor's employer identification number, and the plan identification number; (2) a statement as to whether the plan's funded current liability percentage for the previous plan year is at least 100 percent (and if not, a statement of the percentage); (3) an explanation of the limitations on the guarantee of benefits by the PBGC and the circumstances in which the guarantee would come into effect; and (4) any additional information which the plan administrator elects to include.

The plan explanation notice must be provided no later than two months after the due date (including extensions) for filing the plan's annual report for the previous plan year and may be issued with another document, including the required summary annual report. The funding notice must be written so as to be understood by the average plan participant and may be provided in written, electronic, or some other appropriate form to the extent that it is reasonably accessible by plan participants and beneficiaries.

Solvency notice

Under the proposal, the administrator of a multiemployer plan is required to provide participants with a special notice, a "solvency" notice, if the value of the plan's assets as of the end of the plan year is less than five times the amount of benefit paid by the plan for the plan year. A solvency notice must include: (1) identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan's principal administrative officer, the plan sponsor's employer identification number, and the plan identification number; (2) a statement of the value of the plan's assets, the amount of benefit payments, and the ratio of the assets to the payments for the previous plan year; (3) a summary of the rules governing insolvent multiemployer plans, including the applicable limitation on benefit payments and possible benefit reductions and suspensions, and their potential effect on the plan; (4) a general description of the benefits under the plan that are eligible to be guaranteed by the PBGC, an explanation of the limitations on the guarantee of benefits by the PBGC, and the circumstances in which the guarantee would come into effect; and (4) any additional information which the plan administrator elects to include.

The solvency notice must be provided no later than the due date (including extensions) for filing the plan's annual report for the previous plan year and may be issued with another document, including the annual funding notice. The solvency notice must be written so as to be understood by the average plan participant and may be provided in written, electronic, or some other appropriate form to the extent that it is reasonably accessible by plan participants and beneficiaries.

Effective Date

The proposal applies to plan years beginning after December 31, 2004.

O. No Reduction in Unemployment Compensation as a Result of Pension Rollovers

Present Law

Under present law, unemployment compensation payable by a State to an individual generally is reduced by the amount of retirement benefits received by the individual. Distributions from certain employer-sponsored retirement plans or IRAs that are transferred to a similar retirement plan or IRA ("rollover distributions") generally are not includible in income. Some States currently reduce the amount of an individual's unemployment compensation by the amount of a rollover distribution.

Description of Proposal

The proposal amends the Code so that the reduction of unemployment compensation payable to an individual by reason of the receipt of retirement benefits does not apply in the case of a rollover distribution.

Effective Date

The proposal is effective for weeks beginning on or after the date of enactment.

P. Withholding on Certain Distributions from Governmental Eligible Deferred Compensation Plans

Present Law

Before the Economic Growth and Tax Relief Reconciliation Act of 2001[52] ("EGTRRA"), distributions from an eligible deferred compensation plan under section 457 (a "section 457 plan") were subject to the withholding rules for wages, rather than the withholding rules for distributions from qualified retirement plans. Under the wage withholding rules, graduated withholding applies based on the amount of the wages. Under the withholding rules for qualified retirement plans, an individual may generally elect not to have taxes withheld from distributions. However, withholding is required at a 20-percent rate in the case of an eligible rollover distribution that is not automatically rolled over into another retirement plan. Eligible rollover distributions include distributions that are payable over a period of less than 10 years.

EGTRRA conformed the rollover rules and withholding rules for governmental section 457 plans to the rules for qualified retirement plans.[53] The EGTRRA changes are effective for distributions after December 31, 2001. As a result, as of 2002, required withholding at a 20-percent rate applies to distributions made from a governmental section 457 plan for a period of less than 10 years, including distributions that began before the effective date of the EGTRRA changes.

Description of Proposal

Under the proposal, the pre-EGTRRA withholding rules may be applied to distributions from a governmental section 457 plan if the distribution is part of a series of distributions which began before January 1, 2002, and is payable for less than 10 years.

Effective Date

The proposal is effective as if included in EGTRRA.

[52] Pub. L. No. 107-16.

[53] EGTRRA sec. 641.

Q. Minimum Cost Requirement

Present Law

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.[54] A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. No qualified transfer may be made after December 31, 2005.

Excess assets generally means the excess, if any, of the value of the plan's assets[55] over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003),[56] or (2) 125 percent of the plan's current liability. In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

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[54] Sec. 420.

[55] The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

[56] These amounts relate to the full funding limit for defined benefit plans. The current liability full funding limit is repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for a transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to for a transfer to be qualified, the transfer must meet the minimum cost requirement. To satisfy the minimum cost requirement, an employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years (referred to as the cost maintance period). The applicable employer cost during the cost maintenance period cannot be less than the higher of the applicable employer costs for each of the two taxable years preceding the taxable year of the transfer. The applicable employer cost is generally determined by dividing the current retiree health liabilities by the number of individuals provided coverage for applicable health benefits during the year. The Secretary is directed to prescribe regulations as may be necessary to prevent an employer who significantly reduces retiree health coverage during the period from being treated as satisfying the minimum cost requirement.

Under Treasury regulations,[57] the minimum cost requirement is not satisfied if the employer significantly reduces retiree health coverage during the cost maintenance period. Under the regulations, an employer significantly reduces retiree health coverage for a year (beginning after 2001) during the cost maintenance period if either (1) the employer-initiated reduction percentage for that taxable year exceeds 10 percent, or (2) the sum of the employer-initiated reduction percentages for that taxable year and all prior taxable years during the cost maintenance period exceeds 20 percent.[58] The employer-initiated reduction percentage is percentage of the number of individuals receiving coverage for applicable health benefits as of the day before the first day of the taxable year over the total number of such individuals whose coverage for applicable health benefits ended during the taxable year by reason of employer action.[59]

Description of Proposal

The proposal provides that an employer does not fail the minimum cost requirement if, in lieu of any reduction of health coverage permitted by Treasury regulations, the employer reduces applicable employer cost by an amount not in excess of the reduction in costs which would have occurred if the employer had made the maximum permissible reduction in retiree health coverage under such regulations.

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[57] Treas. Reg. sec. 1.420-1(a).

[58] Treas. Reg. sec. 1.420-1(b)(1).

[59] Treas. Reg. sec. 1.420-1(b)(2).

In applying such regulations to any subsequent taxable year, any reduction in applicable employer cost under the proposal shall be treated as if it were an equivalent reduction in retiree health coverage.

Effective Date

The proposal is effective for taxable years ending after date of enactment.

R. Social Security Coverage Under Divided Retirement System for Public Employees in Kentucky

Present Law

Under Section 218 of the Social Security Act, a State may choose whether or not its State and local government employees who are covered by an employer-sponsored pension plan may also participate in the Social Security Old-Age, Survivors, and Disability Insurance program. (In this context, the term "employer-sponsored pension plan" refers to a pension, annuity, retirement, or similar fund or system established by a State or a political subdivision of a State such as a town. Under present law, State or local government employees not covered by an employer-sponsored pension plan already are, with a few exceptions, mandatorily covered by Social Security.)

Social Security coverage for employees covered under a State or local government employer-sponsored pension plan is established through an agreement between the State and the Federal Government. In most States, before the agreement can be made, employees who are members of the employer-sponsored pension plan must agree to Social Security coverage by majority vote in referendum. If the majority vote is in favor of Social Security coverage, then the entire group, including those voting against such coverage, will be covered by Social Security. If the majority vote is against Social Security coverage, then the entire group, including those voting in favor of such coverage and employees hired after the referendum, will not be covered by Social Security.

In certain States, however, if employees who already are covered in an employer-sponsored pension plan are not in agreement about whether to participate in the Social Security system, coverage can be extended only to those who choose it, provided that all newly hired employees of the system are mandatorily covered under Social Security. To establish such a divided retirement system, the state must conduct a referendum among members of the employer-sponsored pension plan. After the referendum, the retirement system is divided into two groups, one composed of members who elected Social Security coverage and those hired after the referendum, and the other composed of the remaining members of the employer-sponsored pension plan. Under Section 218(d)(6)(c) of the Social Security Act, 21 states currently have authority to operate a divided retirement system.

Description of Proposal

The proposal permits the state of Kentucky to join the 21 other states in being able to offer a divided retirement system. This system would permit current state and local government workers in an employer-sponsored pension plan to elect Social Security coverage on an individual basis. Those who do not wish to be covered by Social Security would continue to participate exclusively in the employer-sponsored pension plan.

The governments of the City of Louisville and Jefferson County were to have been merged in January 2003 and a new retirement system was to be formed. Under the proposal, each employee under the new system could choose whether or not to participate in the Social Security system in addition to their employer-sponsored pension plan. As under present law, all employees newly hired to the system after the divided system is in place would be covered automatically under Social Security.

Effective Date

The proposal is effective on January 1, 2003.

S. Replacement of Interest Rate on 30-Year Treasury Securities Used for Certain Pension Plan Purposes

Present Law

Funding rules

In general

Defined benefit pension plans are subject to both minimum and maximum[60] 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,[61] additional contributions to a plan are generally required if the plan's funded current liability percentage is less than 90 percent.[62] 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

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[60] 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. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent (for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets (i.e., the average fair market value over a period of years). The full funding limit based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter.

[61] 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.

[62] 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.

includes the amount equal to 30 percent of unfunded liabilities.[63] 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 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 and mortality table

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.[64] The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[65] 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.[66] 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 Job Creation and Worker Assistance Act of 2002[67] 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.[68]

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

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

[65] 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.

[66] 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.

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

[68] 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

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.[69] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[70]

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.

Deductions for contributions

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.

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

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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 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.

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

[70] Rev. Rul. 95-28, 1995-1 C.B. 74. The IRS and Treasury Department have announced that they are undertaking a review of the applicable mortality table. Announcement 2000-7, 2000-1 C.B. 586.

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, 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.

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

Interest rate

The proposal changes the interest rate used for purposes of funding requirements and PBGC premiums for plan years beginning after December 31, 2003. The proposal also changes the interest rate used for purposes of determining lump sum distributions for plan years beginning after December 31, 2006. The interest rate used for these purposes is based on rates of interest on corporate bonds. The interest rate required for plans years beginning after December 31, 2006, is phased in over five years.

In determining a plan's current liability, for plan years beginning after December 31, 2003, the proposal changes the upper limit on the permissible range of the weighted average of the interest rates for the four-year period ending on the last day before the plan year begins to 100 percent.

For plan years beginning after December 31, 2003, the proposal replaces the 30-year Treasury rate with the rate of interest on amounts conservatively invested in long-term corporate bonds for purposes of funding requirements and PBGC premiums.[71] 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.

Under the proposal, for plan years beginning after December 31, 2006, the interest rate used for purposes of funding requirements, PBGC premiums, and determining lump-sum distributions is based on a yield curve reflecting interest rates on corporate bonds of various durations. Under the proposal, the use of a yield curve is phased in at a rate of 20 percent each year over five years beginning after December 31, 2006. During the phase-in period, the interest rate used is based on a combination of the yield curve and the previously applicable rate. For funding requirements and PBGC premiums, the previously applicable rate is the rate of interest on amounts conservatively invested in long-term corporate bonds.[72] For determining lump-sum distributions, the previously applicable rate is the 30-year Treasury rate. The yield curve is completely phased in for years beginning after December 31, 2010.

[71] Thus, for plan years beginning after December 31, 2003, and before January 1, 2007, 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.

[72] In determining current liability, the weighted average of the interest rates for the four-year period ending on the last day before the plan year begins is used.

The Department of Treasury shall adopt, through regulations, a methodology for developing a yield curve of interest rates on corporate bonds. Using this methodology, the Department of Treasury shall develop and publish a yield curve reflecting interest rates for high-quality corporate bonds of varying maturities.

In addition, for years beginning after December 31, 2006, the Department of Treasury is directed to publish a single composite rate, based on the yield curve, that can be used in lieu of the yield curve for purposes of PBGC premiums and lump-sum distributions. The composite rate could also be used by plans with 100 or fewer participants to calculate current liability.

Under the provision, 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 for plan years beginning after December 31, 2003. For 2004 and 2005, the resulting benefits will be the greater of the benefit determined using 5.5 percent or the applicable interest rate in effect as of the last day of the plan year beginning before January 1, 2004.

Deficit reduction contribution

The proposal provides that, if a deficit reduction contribution was not required to be made to a plan for the plan year beginning after December 31, 1999, and before January 1, 2001, deficit reduction contributions are not required to be made to the plan for plan years beginning after December 31, 2003, and before December 31, 2006.

Deductions for contributions

The proposal increases the limit on deductions for contributions to a defined benefit plan. Under the proposal, the maximum amount otherwise deductible is not less than 130 percent of the plan's unfunded current liability (i.e., 130 percent of the plan's current liability less the value of plan assets).

Benefit limitations for certain underfunded plans

Under the proposal, if a plan is sponsored by a firm with a below-investment grade rating for two of the past five years, and if the fair market value of assets is less than 50 percent of current liability for vested benefits under the plan as determined for the PBGC variable premium calculation, benefit improvements would be prohibited, the plan would be frozen (no accruals resulting from additional service, age or salary growth) and lump sum payments would be prohibited. The measurement would be made as of the first day of a plan year.

The prohibitions would be effective on the first day of the plan year following the year of the determination. For collectively bargained plans, the prohibitions would be effective on the first day of the next collective bargaining agreement.

Prohibitions would be lifted on the first day of the plan year in which the company's rating has been investment grade for five years, or assets exceed 50 percent of current liability for vested accrued benefits, provided that assets exceed the 50 percent threshold on that date after any increases are considered.

Treasury recommendations

Under the proposal, Treasury is required by December 31, 2004, to issue recommendations for future changes to the funding rules to strengthen the funded status of plans, including recommendations relating to the disclosure of funded status.

Effective Date

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

T. Studies

Present Law

Qualified retirement plans are broadly classified into two categories under the Code, defined benefit plans and defined contribution plans, based on the nature of the benefits provided. Under a defined benefit plan, benefits are determined under a plan formula, such as a formula based on the participant's compensation and years of service. Subject to certain limits, benefits under a defined benefit plan are guaranteed by the PBGC.

Under a defined contribution plan, benefits are based solely on contributions allocated to separate accounts for each plan participant (as adjusted by gains, losses, and expenses). Benefits under defined contribution plans are not insured by the PBGC.

Under ERISA, defined contribution plans are referred to as "individual account plans." Individual account plans may provide that plan participants may direct the investment of assets allocated to their accounts. If certain requirements are satisfied, ERISA fiduciary liability does not apply to investment decisions made by plan participants under an individual account plan.[73]

ERISA generally prohibits qualified retirement plans from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities.[74] This 10-percent limitation does not apply to eligible individual account plans.

A floor-offset arrangement is an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under an individual account plan. The 10-percent limitation on the acquisition of employer securities applies to an individual account plan that is part of a floor-offset arrangement, unless the floor-offset arrangement was established on or before December 17, 1987.

An employee stock ownership plan (an "ESOP") is an individual account plan that is designed to invest primarily in employer securities and which meets certain other requirements. ESOPs are not subject to the 10-percent limit on the acquisition of employer securities, unless the ESOP is part of a floor-offset arrangement (as described above).

Description of Proposal

Study regarding fees charged by individual account plans

The Department of Labor is directed to undertake a study of the administrative and transaction fees incurred by participants, beneficiaries, or plans in connection with the investment of assets under individual account plans. In conducting the study, the Department of

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[73] ERISA sec. 404(c).

[74] ERISA sec. 407. The 10-percent limitation also applies to employer real property.

Labor is to consider how such fees compare to fees charged for similar services provided to investors not in individual account plans and whether participants and beneficiaries are adequately notified of such fees.

The Department of Labor is to report the results of the study, together with any recommendations for legislative changes, within two years after the date of enactment, to the Senate Committees on Finance and Health, Education, Labor, and Pensions and to the House Committees on Ways and Means and Education and the Workforce.

Study on revitalizing defined benefit plans

The Department of Treasury, the Department of Labor, and the PBGC are directed to jointly undertake a study on ways to revitalize employer interest in defined benefit plans. In conducting the study, the Treasury and Labor Departments and the PBGC are to consider: (1) ways to encourage the establishment of defined benefit plans by small and mid-sized employers; (2) ways to encourage the continued maintenance of defined benefit plans by larger employers; and (3) legislative proposals to accomplish these objectives.

Within two years after the date of enactment, the results of the study, together with any recommendations for legislative changes, are to be reported to the Senate Committees on Finance and Health, Education, Labor, and Pensions and to the House Committees on Ways and Means and Education and the Workforce.

Study on floor-offset ESOPs

The Department of the Treasury and the PBGC are directed to undertake a study to determine the number of floor-offset ESOPs still in existence and the extent to which such plans pose a risk to plan participants or beneficiaries or the PBGC. The study is to consider legislative proposals to address the risks posed by floor-offset ESOPs.

Within one year after the date of enactment, the Department of Treasury and the PBGC are to report the results of the study, together with any recommendations for legislative changes, to the Senate Committees on Finance and Health, Education, Labor, and Pensions and the House Committees on Ways and Means and Education and the Workforce.

Effective Date

The provisions are effective on the date of enactment.

U. Purchase of Permissive Service Credit

Present Law

In general

Present law imposes limits on contributions and benefits under qualified plans.[75] 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.[76]

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.[77]

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

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[75] Sec. 415.

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

[77] Priv. Ltr. Rul. 200229051 (April 26, 2002).

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

Under EGTRRA, 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).[78]

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 provides that trustee-to-trustee transfers under sections 457(e)(17) and 403(b)(13) may be from any governmental plan. 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 under such governmental plan, 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.

The proposal allows participants to purchase credit and also allows credit to be purchased for periods regardless of whether service is performed.

Under the proposal, service as an employee of an educational organization providing elementary or secondary education can be determined under the law of any State or nation.

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[78] Secs. 403(b)(13) and 457(e)(17).

Effective Date

The proposal is effective as if included in the amendments made by section 1526(a) of the Taxpayer Relief Act of 1997.

V. Rollover of After-Tax Amounts

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.[79]

Description of Proposal

The proposal allows after-tax contributions to be rolled over from a qualified retirement plan to another qualified retirement plan (either a defined contribution or a defined benefit 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 provision is effective for taxable years beginning after December 31, 2003.

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

W. Additional IRA Catch-up Contributions for Certain Individuals

Present Law

Under present law, tax-favored tax treatment applies to qualified retirement plans maintained by employers and to individual retirement arrangements ("IRAs").

Qualified defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a "section 401(k) plan"), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions. Matching contributions are sometimes made in the form of employer stock.

Under present law, an individual may generally make contributions to an IRA up to the lesser of a certain dollar amount or the individual's compensation. The maximum annual dollar limit on IRA contributions to IRAs is $3,000 for 2002-2004, $4,000 for 2005-2007, and $5,000 for 2008, with indexing thereafter. 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.

Description of Proposal

Under the proposal, an eligible individual would be permitted to make additional contributions to an IRA up to $1,500 per year in tax years 2003 though 2005, and $3,000 in tax years 2006 and 2007. To be eligible to make these additional contributions, an individual must have been a participant in a qualified cash or deferred arrangement under which the employer matched at least 50 percent of the employee's contribution to the plan with stock of the employer. In addition, (1) the employer must have filed for bankruptcy, (2) the employer or any other person must have been subject to an indictment or conviction resulting from business transactions related to the bankruptcy, and (3) the individual was a participant in the section 401(k) plan on the date six months before the employer filed for bankruptcy. Any individual eligible to make these additional contributions would not be permitted to make the IRA catch-up contribution for individuals age 50 and older.

Effective Date

The proposal is effective for taxable years beginning after December 31, 2002, and before January 1, 2008.

X. Distributions by an S Corporation to an Employee Stock Ownership Plan

Present Law

Prohibited transaction exemption for ESOP loans

An employee stock ownership plan (an "ESOP") is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer. Special rules apply to ESOPs that do not apply to other types of qualified retirement plans, including a special exemption from the prohibited transaction rules.

Certain transactions between an employee benefit plan and a disqualified person, including the employer maintaining the plan, are prohibited transactions that result in the imposition of an excise tax.[80] Prohibited transactions include, among other transactions, (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, and (3) the transfer to, or use by or for the benefit of, the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, including certain loans to enable an ESOP to purchase employer stock.[81] In such a case, the employer stock purchased with the loan proceeds is generally pledged as security for the loan. Contributions to the ESOP and dividends paid on employer stock held by the ESOP are used to repay the loan. The employer stock is held in a suspense account and released to participants' accounts as the loan is repaid.

A loan to an ESOP is exempt from prohibited transaction treatment if the loan is primarily for the benefit of the participants and their beneficiaries, the loan is at a reasonable rate of interest, and the collateral given to a disqualified person consists of only employer stock. No person entitled to payments under the loan can have the right to any assets of the ESOP other than (1) collateral given for the loan, (2) contributions made to the ESOP to meet its obligations on the loan, and (3) earnings attributable to the collateral and the investment of contributions described in (2).[82] In addition, the payments made on the loan by the ESOP during a plan year cannot exceed the sum of those contributions and earnings during the current and prior years, less loan payments made in prior years.

Dividends paid with respect to C corporation stock held by an ESOP

A C corporation is entitled to deduct an "applicable dividend" paid in cash with respect to employer stock that is held by an ESOP.[83] An "applicable dividend" includes any dividend that,

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[80] Sec. 4975.

[81] Sec. 4975(d)(3). An ESOP that borrows money to purchase employer stock is referred to as a "leveraged" ESOP.

[82] Treas. reg. sec. 54.4975-7(b)(5).

[83] Sec. 404(k). The deduction for dividends paid with respect to employer stock held by an ESOP does not apply to distributions made with respect to stock of an S corporation held by an ESOP.

in accordance with plan provisions, is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer stock (whether or not allocated to participants) with respect to which the dividend is paid.[84] An ESOP of a C corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because an applicable dividend is used to make payments on the loan.[85] In the case of a dividend paid with respect to stock that is allocated to a participant, this relief does not apply unless the plan provides that employer stock with a fair market value of not less than the amount of the dividend is allocated to the participant for the year which the dividend would have been allocated to the participant.

Description of Proposal

Under the proposal, an ESOP maintained by an S corporation will not be treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because a distribution made with respect to employer stock held by the ESOP is used to repay a loan that was used to acquire the stock (whether or not allocated to participants). This relief does not apply in the case of a distribution which is paid with respect to S corporation stock that is allocated to a participant unless the plan provides that employer stock with a fair market value of not less than the amount of such distribution is allocated to the participant for the year which the distribution would have been allocated to the participant.

Effective Date

The proposal is effective January 1, 1998.

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[84] Sec. 404(k)(2). An “applicable dividend” also includes a dividend paid with respect to employer stock that is paid in cash to a participant (either directly or through the plan) or paid to the plan and reinvested in employer stock at the election of the participant, if certain requirements are met.

[85] Sec. 404(k)(5)(B).

Y. 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 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. 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.

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.

Effective Date

The provision is effective on the date of enactment.

Z. 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.[86] 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.

The Code and ERISA provide that, in general, accrued benefits cannot be reduced by a plan amendment.[87] This prohibition on the reduction of accrued benefits is commonly referred to as the "anticutback rule."

Description of Proposal

The proposal permits certain plan amendments made pursuant to the changes made by the bill or by the Economic Growth and Tax Relief Reconciliation Act of 2001[88] ("EGTRRA"), or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of the proposal, then the plan will be treated as being operated in accordance with its terms and the amendment will not violate the anticutback rule. 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, or such later date as provided by the Secretary of the Treasury. Governmental plans are given an additional two years in which to make required plan amendments. 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 proposal does not provide relief from the anticutback rule for periods prior to the effective date of the relevant provision (or regulations) or the plan amendment.

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[86] Sec. 401(b).

[87] Code sec. 411(d)(6)l ERISA sec. 204(g).

[88] Pub. L. No. 107-16.

The Secretary of the Treasury 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 EGTTRA.[89] 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 proposal is effective on the date of enactment.

[89] 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.

V. PROVISIONS RELATING TO EXECUTIVES AND STOCK OPTIONS

A. Repeal of Limitation on Issuance of Treasury Guidance Regarding Nonqualified Deferred Compensation

Present Law

General tax treatment of nonqualified deferred compensation

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[90] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451. Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it can be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A

[90] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[91] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Rulings on nonqualified deferred compensation

In the 1960's and early 1970's, various IRS revenue rulings considered the tax treatment of nonqualified deferred compensation arrangements.[92] Under these rulings, a mere promise to pay, not represented by notes or secured in any way, was not regarded as the receipt of income for tax purposes. However, if an amount was contributed to an escrow account or trust on the individual's behalf, to be paid to the individual in future years with interest, the amount was held to be includible in income under the economic benefit doctrine. Deferred amounts were not currently includible in income in situations in which nonqualified deferred compensation was payable from general corporate funds that were subject to the claims of general creditors and the plan was not funded by a trust, or any other form of asset segregation to which individuals had any prior or privileged claim.[93] Similarly, current income inclusion did not result when the employer purchased an annuity contract to provide a source of funds for its deferred compensation liability if the employer was the applicant, owner and beneficiary of the annuity contract, and the annuity contract was subject to the general creditors of the employer.[94] In these situations, deferred compensation amounts were held to be includible in income when actually received or otherwise made available.

Proposed Treasury regulation 1.61-16, published in the Federal Register for February 3, 1978, provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year.[95]

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[91] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[92] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

[93] Rev. Rul. 69-650, 1969-2 C.B. 106; Rev. Rul. 69-49, 1969-1 C.B. 138.

[94] Rev. Rul. 72-25, 1972-1 C.B. 127. *See also*, Rev. Rul. 68-99, 1968-1 C.B. 193, in which the employer's purchase of an insurance contract on the life of the employee did not result in an economic benefit to the employee if all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable only to the employer.

[95] Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[96] was enacted in response to proposed Treasury regulation 1.61-16. Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.[97]

Description of Proposal

The proposal repeals section 132 of the Revenue Act of 1978. It is intended that the Secretary of the Treasury issue guidance with respect to the tax treatment of nonqualified deferred compensation arrangements focusing on arrangements that improperly defer income consistent with the other provisions of the proposal.

For example, it is intended that the Secretary address what is considered a substantial limitation under the constructive receipt doctrine and situations in which an individual's right to receive compensation is, at least in form, subject to substantial limitations, but in fact is not so limited. It is also intended that the Secretary address arrangements which purport to not be funded, but should be treated as so. In addition, it is intended that the Secretary address arrangements in which assets, by the technical terms of the arrangements, appear to be subject to the claims of an employer's general creditors, but practically are unavailable to creditors.

It is not intended that the Secretary take the position (as taken in proposed Treasury regulation 1.61-16) that all elective nonqualified deferred compensation is currently includible in income.

No inference is intended that the Secretary is prohibited under present law from issuing guidance with respect to nonqualified deferred compensation arrangements or that any existing nonqualified deferred compensation guidance issued by the Secretary is invalid. In addition, no

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[96] Pub. L. No. 95-600.

[97] The legislative history to the provision states that the Congress believed that the doctrine of constructive receipt should not be applied to employees of taxable employers as it would have been under the proposed regulation. The Congress also believed that the uncertainty surrounding the status of deferred compensation plans of taxable organizations under the proposed regulation was not desired and should not be permitted to continue.

inference is intended that any arrangements covered by future guidance provide permissible deferrals of income under present law.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.

B. Taxation of Nonqualified Deferred Compensation

Present Law

In general

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine,[98] the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for income inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received. If the arrangement is funded, then income is includible for the year in which the individual's rights are transferable or not subject to a substantial risk of forfeiture.

Nonqualified deferred compensation is generally subject to social security and Medicare taxes when the compensation is earned (i.e., when services are performed), unless the nonqualified deferred compensation is subject to a substantial risk of forfeiture. If nonqualified deferred compensation is subject to a substantial risk of forfeiture, it is subject to social security and Medicare tax when the risk of forfeiture is removed (i.e., when the right to the nonqualified deferred compensation vests). This treatment is not affected by whether the arrangement is funded or unfunded, which is relevant in determining when amounts are includible in income (and subject to income tax withholding).

In general, an arrangement is considered funded if there has been a transfer of property under section 83. Under that section, a transfer of property occurs when a person acquires a beneficial ownership interest in such property. The term "property" is defined very broadly for purposes of section 83.[99] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. On the other hand, deferred amounts are generally not includible in income if

[98] *See, e.g.*, *Sproull v. Commissioner*, 16 T.C. 244 (1951), *aff'd per curiam*, 194 F.2d 541 (6th Cir. 1952); Rev. Rul. 60-31, 1960-1 C.B. 174.

[99] Treas. Reg. sec. 1.83-3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.

nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

As discussed above, if the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received under section 451.[100] Income is constructively received when it is credited to an individual's account, set apart, or otherwise made available so that it may be drawn on at any time. Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions. A requirement to relinquish a valuable right in order to make withdrawals is generally treated as a substantial limitation or restriction.

Rabbi trusts

Arrangements have developed in an effort to provide employees with security for nonqualified deferred compensation, while still allowing deferral of income inclusion. A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation, except that the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of insolvency or bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of insolvency or bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[101] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The IRS has issued guidance setting forth model rabbi trust provisions.[102] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that all assets of the trust are subject to the claims of the general creditors of the company in the event of the company's insolvency or bankruptcy.

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[100] Treas. Reg. secs. 1.451-1 and 1.451-2.

[101] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[102] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

Since the concept of rabbi trusts was developed, arrangements have developed which attempt to protect the assets from creditors despite the terms of the trust. Arrangements also have developed which effectively allow deferred amounts to be available to individuals, while still meeting the safe harbor requirements set forth by the IRS.

Description of Proposal

Under the proposal, all amounts deferred under a nonqualified deferred compensation plan[103] for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture[104] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the proposal are not satisfied, in addition to current income inclusion, interest at the underpayment rate is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. In addition, the amount required to be included in income is subject to an additional ten percent tax. Actual or notional earnings on amounts deferred are also subject to the proposal.

Under the proposal, distributions from a nonqualified deferred compensation plan may be allowed only upon separation from service, death, a specified time (or pursuant to a fixed schedule), change in control, occurrence of an unforeseeable emergency, or if the participant becomes disabled. A nonqualified deferred compensation plan may not allow distributions other than upon the permissible distribution events and may not permit acceleration of a distribution.

In the case of a specified employee, distributions upon separation from service may not be made earlier than six months after the date of the separation from service. Specified employees are key employees (as defined in section 416(i)) of publicly-traded corporations.

Amounts payable at a specified time or pursuant to a fixed schedule must be specified under the plan at the time of deferral. Amounts payable upon the occurrence of an event are not treated as amounts payable at a specified time. For example, amounts payable when an individual attains age 65 are payable at a specified time, while amounts payable when an individual's child begins college are payable upon the occurrence of an event.

Distributions upon a change in the ownership or effective control of a corporation, or in the ownership of a substantial portion of the assets of a corporation, may only be made to the extent provided by the Secretary. It is intended that the Secretary use a similar, but more restrictive, definition of change in control as used for purposes of the golden parachute provisions of section 280G consistent with the purposes of the proposal. In the case of an individual who, with respect to a corporation, is subject to the requirements of section 16(a) of the Securities Act of 1934, distributions upon a change in control may not be made earlier than

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[103] A plan includes an agreement or arrangement, including an agreement or arrangement that includes one person.

[104] As under section 83, the rights of a person to compensation are subject to a substantial risk of forfeiture if the person's rights to such compensation are conditioned upon the performance of substantial services by any individual.

one year after the date of the change in control. Such individuals include officers (as defined by section 16(a)),[105] directors, or 10-percent owners of publicly-held corporations. Under the proposal, distributions made to such individuals upon a change in control are treated as excess parachute payments under section 280G (even if the payment would not otherwise be treated as an excess parachute payment) and subject to the excise tax under section 4999.

Unforeseeable emergency is defined as severe financial hardship of the participant or beneficiary resulting from an illness or accident of the participant or beneficiary, the participant's or beneficiary's spouse or the participant's or beneficiary's dependent (as defined in 152(a)); loss of the participant's or beneficiary's property due to casualty; or other similar extraordinary and unforeseeable circumstances arising as a result of events beyond the control of the participant or beneficiary. The amount of the distribution must be limited to the amount needed to satisfy the hardship plus taxes. Distributions can not be allowed to the extent that the hardship may be relieved through reimbursement or compensation by insurance or otherwise, or by liquidation of the participant's assets (to the extent such liquidation would not itself cause financial hardship).

A participant is considered disabled if he or she (i) 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 which has lasted or can be expected to last for a continuous period of not less than 12 months; or (ii) is receiving income replacement benefits under an accident and health plan covering employees of the individual's employer.

Under the proposal, investment options (including phantom or theoretical investment options) which a participant may elect under the nonqualified deferred compensation plan must be comparable to those which may be elected by participants of the qualified employer plan that has the fewest investment options. It is intended that the investment options of the nonqualified deferred compensation plan may be less favorable or more limited than those of the qualified employer plan. It is intended that open brokerage windows, hedge funds, and investments in which the employer guarantees a rate of return above what is commercially available are prohibited. If there is no qualified employer plan that allows participants to direct investments, the Secretary shall prescribe guidance regarding permissible investment options.

The proposal requires that initial deferral elections must be required to be made at least prior to the beginning of the taxable year in which the compensation is earned, or at such other time as provided in Treasury regulations. In the first year that an employee becomes eligible for participation in a nonqualified deferred compensation plan, the election may be made within 30 days after the date that the employee is initially eligible. Under the proposal, a plan may allow changes in the time and form of distributions subject to certain requirements. A nonqualified deferred compensation plan may allow subsequent elections to delay the timing or form of distributions only if (1) the subsequent election is made not less than 12 months prior to the date

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[105] An officer is defined as the president, principal financial officer, principal accounting officer (or, if there is no such accounting officer, the controller), any vice-president in charge of a principal business unit, division or function (such as sales, administration or finance), any other officer who performs a policy-making function, or any other person who performs similar policy-making functions.

of the first scheduled payment, and (2) the additional deferral with respect to which such election is made is for a period of not less than five years. An individual cannot be permitted to make more than one subsequent election with respect to an amount deferred. As previously discussed, no accelerations of distributions may be allowed. For example, changes in the form of a distribution from an annuity to a lump sum are not permitted.

If impermissible distributions or elections are made, or if the nonqualified deferred compensation plan allows impermissible distributions or elections, all amounts deferred under the plan (including amounts deferred in prior years) are currently includible in income to the extent not subject to a substantial risk of forfeiture and not previously included in income. In addition, interest at the underpayment rate is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. An additional ten percent tax also applies to the amount required to be included in income.

Under the proposal, assets set aside (directly or indirectly) in an offshore trust (or other similar arrangement) for the purpose of paying nonqualified deferred compensation are treated as property transferred in connection with the performance of services under section 83 at the time set aside or transferred outside of the United States (whether or not such assets are available to satisfy the claims of general creditors). Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation. The amount required to be included in income is also subject to an additional ten percent tax. The proposal does not apply to assets located in a foreign jurisdiction if substantially all of the services to which the nonqualified deferred compensation relates are performed in such foreign jurisdiction. The proposal is specifically intended to apply to foreign trusts and arrangements that effectively shield from the claims of general creditors any assets intended to satisfy nonqualified deferred compensation arrangements. The Secretary has authority to exempt arrangements from the provision if the arrangements do not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors.

Under the proposal, a transfer of property in connection with the performance of services under section 83 also occurs if a nonqualified deferred compensation plan provides that, upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation. The transfer of property occurs as of the earlier of when the assets are so restricted or when the plan provides that assets will be restricted. Any increases in the value of, or any earnings with respect to, such assets are treated as additional transfers of property. Interest at the underpayment rate is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year such assets were first set aside for purposes of nonqualified deferred compensation. The amount required to be included in income is also subject to an additional ten percent tax.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.[106] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the proposal.

Interest imposed under the proposal is treated as interest on an underpayment of tax. Income (whether actual or notional) attributable to nonqualified deferred compensation is treated as additional deferred compensation and is subject to the provisions of the proposal. The proposal is not intended to prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the proposal. The proposal does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The proposal requires annual reporting to the IRS of amounts deferred. Such amounts are required to be reported on an individual's Form W-2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the proposal, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirements do not apply.

The proposal provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of proposal, including regulations: (1) providing for amounts of deferral in the case of defined benefit plans; (2) relating to changes in the ownership and control of a corporation or assets of a corporation; (3) exempting from the provisions providing for transfers of property arrangements that will not result in an improper deferral of U.S. tax and will not result in assets being effectively beyond the reach of creditors; (4) defining financial health; and (5) disregarding a substantial risk of forfeiture in cases where necessary to carry out the purposes of the proposal.

It is intended that substantial risk of forfeitures may not be used to manipulate the timing of income inclusion. It is intended that substantial risks of forfeiture should be disregarded in cases in which they are illusory or are principally used to postpone the timing of income inclusion. For example, if an executive is effectively able to control the acceleration of the lapse of a substantial risk of forfeiture, such risk of forfeiture should be disregarded and income inclusion should not be postponed on account of such restriction.

Effective Date

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

[106] A qualified employer plan also includes a section 501(c)(18) trust.

C. Denial of Deferral of Certain Stock Option and Restricted Stock Gains

Present Law

Section 83 applies to transfers of property in connection with the performance of services. Under section 83, if, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of the fair market value of such property over the amount (if any) paid for the property is includible in income at the first time that the property is transferable or not subject to substantial risk of forfeiture.

Stock granted to an employee (or other service provider) is subject to the rules that apply under section 83. When stock is vested and transferred to an employee, the excess of the fair market value of the stock over the amount, if any, the employee pays for the stock is includible in the employee's income for the year in which the transfer occurs.

The income taxation of a nonqualified stock option is determined under section 83 and depends on whether the option has a readily ascertainable fair market value. If the nonqualified option does not have a readily ascertainable fair market value at the time of grant, no amount is includible in the gross income of the recipient with respect to the option until the recipient exercises the option. The transfer of stock on exercise of the option is subject to the general rules of section 83. That is, if vested stock is received on exercise of the option, the excess of the fair market value of the stock over the option price is includible in the recipient's gross income as ordinary income in the taxable year in which the option is exercised. If the stock received on exercise of the option is not vested, the excess of the fair market value of the stock at the time of vesting over the option price is includible in the recipient's income for the year in which vesting occurs unless the recipient elects to apply section 83 at the time of exercise.

Other forms of stock-based compensation are also subject to the rules of section 83.

Description of Proposal

Under the proposal, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other employer security based compensation cannot be deferred by electing to receive a future payment in lieu of such amounts. The proposal applies even if the future right to payment is treated as an unfunded to promise to pay.

The proposal is not intended to imply that such practices result in permissive deferral of income under present law.

Effective Date

The proposal is effective after December 31, 2003.

D. Increase in Withholding from Supplemental Wage Payments in Excess of $1 Million

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate,[107] based on the third lowest income tax rate under the Code (25 percent for 2003).[108]

Description of Proposal

Under the proposal, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year are subject to withholding at the highest income tax rate (35 percent for 2003), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule applies only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) are not affected.

Effective Date

The proposal is effective with respect to payments made after December 31, 2003.

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[107] Sec. 13273 of the Revenue Reconciliation Act of 1993.

[108] Sec. 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.

E. 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.[109]

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.[110] The applicable Code provisions[111] 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 in Notice 2002-47[112] 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 the stock acquired pursuant to the exercise of a statutory stock option.

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, FICA and FUTA taxes do not apply upon the exercise of a statutory stock option.[113] The

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[109] Sec. 421.

[110] Secs. 3101, 3111 and 3301.

[111] Secs. 3121 and 3306.

[112] Notice 2002-47, 2002-28 I.R.B. 97.

[113] The provision also provides a similar exclusion for wages under the Railroad Retirement Tax Act.

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 on the date of enactment.

F. Capital Gain Treatment on Sale of Stock Acquired from Exercise of Statutory Stock Options to Comply with Conflict of Interest Requirements

Present Law

Statutory stock options

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. Upon such exercise, an employer is allowed a corresponding compensation deduction. 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.[114]

If an employee disposes of stock acquired upon the exercise of a statutory option, the employee generally is taxed at capital gains rates with respect to the excess of the fair market value of the stock on the date of disposition over the option price, and no compensation expense deduction is allowable to the employer, unless the employee fails to meet a holding period requirement. The employee fails to meet this holding period requirement if the disposition occurs within two years after the date the option is granted or one year after the date the option is exercised. The gain upon a disposition that occurs prior to the expiration of the applicable holding period(s) (a "disqualifying disposition") does not qualify for capital gains treatment. In the event of a disqualifying disposition, the income attributable to the disposition is treated by the employee as income received in the taxable year in which the disposition occurs, and a corresponding deduction is allowable to the employer for the taxable year in which the disposition occurs.

Sale of property to comply with conflict of interest requirements

The Code provides special rules for recognizing gain on sales of property which are required in order to comply with certain conflict of interest requirements imposed by the Federal government.[115] Certain executive branch Federal employees (and their spouses and minor or dependent children) who are required to divest property in order to comply with conflict of interest requirements may elect to postpone the recognition of resulting gains by investing in certain replacement property within a 60-day period. The basis of the replacement property is reduced by the amount of the gain not recognized. Permitted replacement property is limited to any obligation of the United States or any diversified investment fund approved by regulations issued by the Office of Government Ethics. The rule applies only to sales under certificates of divestiture issued by the President or the Director of the Office of Government Ethics.

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[114] Sec. 421.

[115] Sec. 1043.

Description of Proposal

Under the proposal, an eligible person who, in order to comply with Federal conflict of interest requirements, is required to sell shares of stock acquired pursuant to the exercise of a statutory stock option is treated as satisfying the statutory holding period requirements, regardless of how long the stock was actually held. An eligible person generally includes an officer or employee of the executive branch of the Federal Government (and any spouse or minor or dependent children whose ownership in property is attributable to the officer or employee). Because the sale is not treated as a disqualifying disposition, the individual is afforded capital gain treatment on any resulting gains. Such gains are eligible for deferral treatment under section 1043.

The employer granting the option is not allowed a deduction upon the sale of the stock by the individual.

Effective Date

The proposal is effective for sales after the date of enactment.

VI. WOMEN'S PENSION PROTECTION

A. Joint Study of Application of Spousal Consent Rules to Defined Contribution Plans

Present Law

Defined benefit pension plans and money purchase pension plans are required to provide benefits in the form of a qualified joint and survivor annuity ("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 the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse 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.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these conditions include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver. Similar waiver and election rules apply to the waiver of the right of the spouse to be the beneficiary under a defined contribution plan that is not required to provide a QJSA. Spousal consent is also required if the participant's accrued benefit is to be used as security for a loan.

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's vested accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000.

Defined contribution plans other than money purchase pension plans are not required to provide a QJSA or QPSA if the participant does not elect an annuity as the form of payment, the surviving spouse is the beneficiary of the participant's entire vested account balance under the plan (unless the spouse consents to 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). In the case of a defined contribution plan subject to the QJSA and QPSA requirements, a QPSA means an annuity for the life of the surviving spouse that has an actuarial value of at least 50 percent of the participant's vested account balance as of the date of death.

Description of Proposal

The Secretary of Labor and the Secretary of Treasury are required to conduct a joint study of the feasibility and desirability of extending the spousal consent requirements to defined contribution plans to which the requirements do not apply under present law and to report the results thereof, with recommendations for legislative changes, within two years after the date of enactment, to the House Committees on Ways and Means and on Education and the Workforce and the Senate Committees on Finance and on Health, Education, Labor and Pensions. In conducting the study, the Secretary of Labor and the Secretary of Treasury are required to consider (1) any modifications of the spousal consent requirements that are necessary to apply the requirements to defined contribution plans, and (2) the feasibility of providing notice and spousal consent in electronic form that can be authenticated.

Effective Date

The proposal is effective on the date of enactment.

B. Treatment of Subsequent Qualified Domestic Relations Orders

Present Law

Benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, including a former spouse, and that meets certain procedural requirements. A QDRO may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under a domestic relations order previously determined to be a QDRO.

Present law does not provide specific rules for the treatment of a QDRO that is issued subsequent to the issuance of another domestic relations order or that revises another domestic relations order.

Description of Proposal

The Secretary of the Treasury is directed to issue, not later than one year after the date of enactment of the proposal, regulations to clarify the status of certain domestic relations orders. In particular, regulations will clarify that a domestic relations order otherwise meeting the QDRO requirements will not fail to be treated as a QDRO solely because of the time it is issued or because it is issued after or revises another domestic relations order or another QDRO. Under the regulations, such a domestic relations order is in all respects subject to the same requirements and protections that apply to QDROs.

Effective Date

The proposal is effective on the date of enactment.

C. Protection of Rights of Former Spouses Under the Railroad Retirement System

Present Law

In general

The Railroad Retirement system has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system replicates a private pension plan, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement; however, the Federal government collects the Tier II payroll contribution and pays out the benefits.

Former spouses of living railroad employees

Generally, a former spouse of a railroad employee who is otherwise eligible for any Tier I or Tier II benefit cannot receive either benefit until the railroad employee actually retires and begins receiving his or her retirement benefits. This is the case regardless of whether a State divorce court has awarded such railroad retirement benefits to the former spouse.

Former spouses of deceased railroad employees

The former spouse of a railroad employee may be eligible for survivors benefits under Tier I of the Railroad Retirement system. However, a former spouse loses eligibility for any otherwise allowable Tier II benefits upon the death of the railroad employee.

Description of Proposal

Former spouses of living railroad employees

The proposal eliminates the requirement that a railroad employee actually receive railroad retirement benefits for the former spouse to be entitled to any Tier I benefit or Tier II benefit awarded under a State divorce court decision.

Former spouses of deceased railroad employees

The proposal provides that a former spouse of a railroad employee does not lose eligibility for otherwise allowable Tier II benefits upon the death of the railroad employee.

Effective Date

The railroad retirement proposals are effective one year after the date of enactment.

D. Modifications of Joint and Survivor Annuity Requirements

Present Law

Defined benefit pension plans and money purchase pension plans are required to provide benefits in the form of a qualified joint and survivor annuity ("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 the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse 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.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these conditions include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver. Similar waiver and election rules apply to the waiver of the right of the spouse to be the beneficiary under a defined contribution plan that is not required to provide a QJSA. Spousal consent is also required if the participant's accrued benefit is to be used as security for a loan.

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's vested accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000.

Defined contribution plans other than money purchase pension plans are not required to provide a QJSA or QPSA if the participant does not elect an annuity as the form of payment, the surviving spouse is the beneficiary of the participant's entire vested account balance under the plan (unless the spouse consents to 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). In the case of a defined contribution plan subject to the QJSA and QPSA requirements, a QPSA means an annuity for the life of the surviving spouse that has an actuarial value of at least 50 percent of the participant's vested account balance as of the date of death.

Description of Proposal

The proposal revises the QJSA requirements to require that, at the election of the participant, benefits will be paid in the form of a "qualified joint and 3/4 survivor annuity." A qualified joint and 3/4 survivor annuity means an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 75 percent of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

A qualified joint and 3/4 survivor annuity is treated as a QJSA. Thus, if a plan provides a qualified joint and 3/4 survivor annuity, it is not required also to provide an annuity for the life of the participant with a 50-percent survivor annuity for the life of the spouse (i.e., the QJSA required under present law).

Under the proposal, a plan is not treated as having decreased the accrued benefit of a participant solely by reason of the adoption of a plan amendment required to implement the requirement that the plan offer a qualified joint and 3/4 survivor annuity. Accordingly, it is intended that a plan amendment adding a qualified joint and 3/4 survivor annuity option to a plan may eliminate the QJSA option required under present law without violating the present-law provision that prohibits a plan amendment that decreases accrued benefits.

Effective Date

The proposal applies generally to plan years beginning after December 31, 2003. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal applies to plan years beginning on or after the earlier of (1) the later of January 1, 2004, and the last date on which an applicable collective bargaining agreement terminates (without regard to extensions), and (2) January 1, 2005.

VII. TAX COURT PENSION AND COMPENSATION MODERNIZATION

A. Tax Court Judges

Present Law

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[116] The salary of a Tax Court judge is the same salary as received by a United States District Court judge.[117] Present law also provides Tax Court judges with some benefits that correspond to benefits provided to United States District Court judges, including specific retirement and survivor benefit programs for Tax Court judges.[118]

Under the retirement program, a Tax Court judge may elect to receive retirement pay from the Tax Court in lieu of benefits under another Federal retirement program. A Tax Court judge may also elect to participate in a plan providing annuity benefits for the judge's surviving spouse and dependent children (the "survivors' annuity plan"). Generally, benefits under the survivors' annuity plan are payable only if the judge has performed at least five years of service. Cost-of-living increases in benefits under the survivors' annuity plan are generally based on increases in pay for active judges.

Tax Court judges participate in the Federal Employees Group Life Insurance program (the "FEGLI" program). Retired Tax Court judges are eligible to participate in the FEGLI program as the result of an administrative determination of their eligibility, rather than a specific statutory provision.

Tax Court judges are not covered by the leave system for Federal Executive Branch employees. As a result, an individual who works in the Federal Executive Branch before being appointed to the Tax Court does not continue to accrue annual leave under the same leave program and may not use leave accrued prior to his or her appointment to the Tax Court.

Tax Court judges are not eligible to participate in the Thrift Savings Plan.

Tax Court judges are subject to limitations on outside earned income under the Ethics in Government Act of 1978.

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[116] Sec. 7441.

[117] Sec. 7443(c).

[118] Secs. 7447 and 7448.

Description of Proposal

In general

The proposal makes various changes to the compensation and benefits rules that apply to Tax Court judges to eliminate disparities between the treatment of Tax Court judges and the treatment of other Federal judges.

Survivor annuities for assassinated judges

Under the proposal, benefits under the survivors' annuity plan are payable if a Tax Court judge is assassinated before the judge has performed five years of service.

Cost-of-living adjustments for survivor annuities

The proposal provides that cost-of-living increases in benefits under the survivors' annuity plan are generally based on cost-of-living increases in benefits paid under the Civil Service Retirement System.

FEGLI program

Under the proposal, a judge or retired judge of the Tax Court is deemed to be an employee continuing in active employment for purposes of participation in the FEGLI program. In addition, in the case of a Tax Court judge age 65 or over, the Tax Court is authorized to pay on behalf of the judge any increase in employee premiums under the FEGLI program that occur after April 24, 1999,[119] including expenses generated by such payment, as authorized by the chief judge of the Tax Court in a manner consistent with payments authorized by the Judicial Conference of the United States (i.e., the body with policy-making authority over the administration of the courts of the Federal Judicial Branch).

Accrued annual leave

Under the proposal, in the case of a judge who is employed by the Federal Executive Branch before appointment to the Tax Court, the judge is entitled to receive a lump-sum payment for the balance of his or her accrued annual leave on appointment to the Tax Court.

Thrift Savings Plan participation

Under the proposal, Tax Court judges are permitted to participate in the Thrift Savings Plan. A Tax Court judge is not eligible for agency contributions to the Thrift Savings Plan.

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[119] This date relates to changes in the FEGLI program, including changes to premium rates to reflect employees' ages.

Exemption for teaching compensation from outside earned income limitations

Under the proposal, compensation earned by a retired Tax Court judge for teaching is not treated as outside earned income for purposes of limitations under the Ethics in Government Act of 1978.

Effective Date

The proposals are effective on the date of enactment, except that: (1) the proposal relating to cost-of-living increases in benefits under the survivors' annuity plan applies with respect to increases in Civil Service Retirement benefits taking effect after the date of enactment; (2) the proposal relating to payment of accrued annual leave applies to any Tax Court judge with an outstanding leave balance as of the date of enactment and to any individual appointed to serve as a Tax Court judge after such date; (3) the proposal relating to participation by Tax Court judges in the Thrift Savings Plan applies as of the next open season; and (4) the proposal relating to teaching compensation of a retired Tax Court judge applies to any individual serving as a retired Tax Court judge on or after the date of enactment.

B. Special Trial Judges of the Tax Court

Present Law

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[120] The chief judge of the Tax Court may appoint special trial judges to handle certain cases.[121] Special trial judges serve for an indefinite term. Special trial judges receive a salary of 90 percent of the salary of a Tax Court judge and are generally covered by the benefit programs that apply to Federal Executive Branch employees, including the Civil Service Retirement System or the Federal Employees' Retirement System.

Description of Proposal

In general

The proposal is generally designed to eliminate disparities between the treatment of special trial judges of the Tax Court and magistrate judges in the Article III courts.

Magistrate judges of the Tax Court

Under the proposal, the position of special trial judge of the Tax Court is renamed as magistrate judge of the Tax Court. Magistrate judges are appointed (or reappointed) to serve for eight-year terms and are subject to removal in limited circumstances.

Under the proposal, a magistrate judge receives a salary of 92 percent of the salary of a Tax Court judge.

The proposal exempts magistrate judges from the leave program that applies to employees of the Federal Executive Branch and provides rules for individuals who are subject to such leave program before becoming exempt.

Survivors' annuity plan

Under the proposal, magistrate judges of the Tax Court may elect to participate in the survivors' annuity plan for Tax Court judges. An election to participate in the survivors' annuity plan must be filed not later than the latest of six months after: (1) the date of enactment of the proposal; (2) the date the judge takes office; or (3) the date the judge marries.

Retirement annuity program for magistrate judges

The proposal establishes a new retirement annuity program for magistrate judges of the Tax Court, under which a magistrate judge may elect to receive a retirement annuity from the Tax Court in lieu of benefits under another Federal retirement program. A magistrate judge may

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[120] Sec. 7441.

[121] Sec. 7443A.

elect to be covered by the retirement program within five years of appointment or five years of date of enactment. A magistrate judge who elects to be covered by the retirement program generally receives a refund of contributions (with interest) made to the Civil Service Retirement System or the Federal Employees' Retirement System.

A magistrate judge may retire at age 65 with 14 years of service and receive an annuity equal to his or her salary at the time of retirement. For this purpose, service may include service performed as a special trial judge or a magistrate judge, provided the service is performed no earlier than 9-1/2 years before the date of enactment of the proposal. The proposal also provides for payment of a reduced annuity in the case a magistrate judge with at least eight years of service or in the case of disability or failure to be reappointed.

A magistrate judge receiving a retirement annuity is entitled to cost-of-living increases based on cost-of-living increases in benefits paid under the Civil Service Retirement System. However, such an increase cannot cause the retirement annuity to exceed the current salary of a magistrate judge.

Contributions of one percent of salary are withheld from the salary of a magistrate judge who elects to participate in the retirement annuity program. Such contributions must be made also with respect to prior service for which the magistrate judge elects credit under the retirement annuity program. No contributions are required after 14 years of service. A lump sum refund of the magistrate judge's contributions (with interest) is made if no annuity is payable, for example, if the magistrate judge dies before retirement.

The proposal includes rules under which annuity payments may be made to a person other than the magistrate judge in certain circumstances, such as divorce or legal separation.

A magistrate judge's right to a retirement annuity is generally suspended or reduced in the case of employment outside the Tax Court.

The proposal establishes the Tax Court Judicial Officers' Retirement Fund (the "Fund"). Amounts in the Fund are authorized to be appropriated for the payment of annuities, refunds, and other payments under the retirement annuity program. Contributions withheld from a magistrate judge's salary are deposited in the Fund. In addition, the proposal authorizes to be appropriated to the Fund amounts required to reduce the Fund's unfunded liability to zero. For this purpose, the Fund's unfunded liability means the estimated excess, actuarially determined on an annual basis, of the present value of benefits payable from the Fund over the sum of (1) the present value of contributions to be withheld from the future salary of the magistrate judges and (2) the balance in the Fund as of the date the unfunded liability is determined.

Under the proposal, a magistrate judge who elects to participate in the retirement annuity program is also permitted to participate in the Thrift Savings Plan. Such a magistrate judge is not eligible for agency contributions to the Thrift Savings Plan.

<u>Retirement annuity rule for incumbent magistrate judges</u>

The proposal provides a transition rule under which a magistrate judge in active service on the date of enactment of the proposal.

Under the transition rule, such a magistrate judge is entitled to an annuity under the Civil Service Retirement System or the Federal Employees' Retirement System based on prior service that is not credited under the magistrate judges' retirement annuity program. If the magistrate judge made contributions to the Civil Service Retirement System or the Federal Employees' Retirement System with respect to service that is credited under the magistrate judges' retirement annuity program, such contributions are refunded (with interest).

A magistrate judge who elects the transition rule is also entitled to the annuity payable under the magistrate judges' retirement program in the case of retirement with at least eight years of service or on failure to be reappointed. This annuity is based on service as a magistrate judge or special trial judge of the Tax Court that is performed no earlier than 9-1/2 years before the date of enactment of the proposal and for which the magistrate judge makes contributions of one percent of salary.

Recall of retired magistrate judges

The proposal provides rules under which a retired magistrate judge may be recalled to perform services for a limited period.

Effective Date

The proposals are effective on date of enactment.

VIII. OTHER PROVISIONS

A. Exclusion for Education Benefits Provided by Employers on Children of Employees

Present Law

If certain requirements are satisfied, employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply with respect to education provided to an individual other than the employee, e.g., a child of the employee.

Section 117 provides that, if certain conditions are satisfied, a qualified scholarship is excludable from the gross income of an individual who is a candidate for a degree.

Description of Proposal

The proposal provides that post-secondary educational benefits provided to children of employees are excludable from the gross income and wages of the employee under section 127. The maximum amount excludable for a taxable year with respect to a child of an employee may not exceed $2,000. In addition, the aggregate annual amount excludable from an employee's income for a year with respect to education of the employee and education of the employee's children cannot exceed $5,250.

Effective Date

The proposal is effective for taxable years beginning after the date of enactment.