Joint Committee on Taxation
September 17, 2003
JCX-78-03

# DESCRIPTION OF CHAIRMAN’S MODIFICATION TO THE “NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT OF 2003”

## I. MODIFICATIONS TO PROVISIONS IN THE CHAIRMAN’SMARK

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

The modification adds a transition rule with respect to employer matching and nonelective contributions (and earnings thereon) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum. Under the transition rule, the diversification requirements apply to such preferred stock for plan years beginning after the earlier of (1) December 31, 2006; or (2) the first date as of which the actual value of the preferred stock equals or exceeds the guaranteed minimum.

### B. Rollover of After-Tax Amounts

The modification adds a provision allowing after-tax contributions to be rolled over into a tax-sheltered annuity that separately accounts for such contributions (and earnings thereon).

### C. Exclusion for Education Benefits Provided by Employers to Children of Employees

The exclusion for education benefits provided by employers to children of employees is modified by providing that the exclusion does not apply for employment tax purposes, the amount excludable is limited to $1,000, and the exclusion does not apply to years beginning after December 31, 2005.

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

The proposal providing that 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 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, is effective after December 31, 2006. Treasury is directed to issue regulations by December 31, 2005.

## II. PROVISIONS DELETED FROM THE CHAIRMAN'S MARK

The following items are deleted from the Chairman's mark:

(1) Inapplicability of relief from fiduciary liability during suspension of ability of participant or beneficiary to direct investments;

(2) Liability for breach of fiduciary duty;

(3) Increase in maximum bond amount;

(4) Provisions relating to whistleblower actions involving pension plans;

(5) Increase in penalties for coercive interference with exercise of ERISA rights;

(6) Technical corrections to SAVER Act;

(7) Benefit suspension notice;

(8) Automatic rollovers of certain mandatory distribution; and

(9) Study regarding fees charged by individual account plans.

## III. ADDITIONAL PROVISIONS

### A. Exclusion from Gross Income for Amounts Paid Under National Health Service Corps Loan Repayment Program

#### Present Law

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides loan repayments to participants on condition that the participants provide certain services. In the case of the NHSC Loan Repayment Program, the recipient of the loan repayment is obligated to provide medical services in a geographic area identified by the Public Health Service as having a shortage of health-care professionals. Loan repayments may be as much as $35,000 per year of service plus a tax assistance payment of 39 percent of the repayment amount.

Generally, gross income means all income from whatever source derived including income for the discharge of indebtedness. However, gross income does not include discharge of indebtedness income if: (1) the discharge occurs in a Title 11 case; (2) the discharge occurs when the taxpayer is insolvent; (3) the indebtedness discharged is qualified farm indebtedness; or (4) except in the case of a C corporation, the indebtedness discharged is qualified real property business indebtedness.

Because the loan repayments provided under the NHSC Loan Repayment Program are not specifically excluded from gross income, they are gross income to the recipient.

## Description of Proposal

The proposal excludes from gross income loan repayments provided under the NHSC Loan Repayment Program.

## Effective Date

The provision is effective with respect to amounts received in taxable years beginning after December 31, 2003.

## B. Pension Plan Reporting Simplification

## Present Law

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return.[1] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

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

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

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

## Description of Proposal

The Secretary of the Treasury and the Secretary of Labor are directed to modify the annual return filing requirements with respect to plans that satisfy the eligibility requirements for Form 5500-EZ (referred to as a "one-participant retirement plan") to provide that if the total value of the plan assets of such a plan as of the end of the plan year does not exceed $250,000, the plan administrator is not required to file a return. In addition, the proposal directs the Secretary of the Treasury and the Secretary of Labor to provide simplified reporting requirements for plan years beginning after December 31, 2004, for certain plans with fewer than 25 employees.

## Effective Date

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

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

## Present Law

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

## Description of Proposal

Under the provision, the 10-percent early withdrawal tax does not apply to distributions from a governmental defined benefit plan to a qualified safety employee who separates from service after age 50. A qualified public safety employee is an employee of any police department or fire department organized and operated by a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

## Effective Date

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

## D. Updating Deduction Rules for Combination of Plans

### Present Law

Employer contributions to qualified retirement plans are deductible subject to certain limits.[2] In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit plan, the employer generally may deduct the amount necessary to satisfy the minimum funding requirement of the plan for the year. In addition, in order to encourage plan sponsors to fully fund defined benefit plans, the maximum amount otherwise deductible generally is not less than the plan's unfunded current liability. In the case of a plan that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program. Contributions in excess of the full funding limit are generally not deductible.[3]

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

If an employer sponsors one or more defined benefit plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year.[4] The overall deduction limit generally is the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year (or the amount of either the plan's unfunded current liability or the plan's unfunded termination liability in the case of a terminating plan).

Under EGTRRA, elective deferrals are not subject to the limits on deductions and are not taken into account in applying the limits to other employer contributions.[5] The combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.[6] Certain contributions to a defined contribution plan that are

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[2] Sec. 404.

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

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

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

[6] Sec. 4972.

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

## Description of Proposal

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

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

## Effective Date

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

# E. Permit Qualified Transfers of Excess Pension Assets to Retiree Health Accounts by Multiemployer Plan

## 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.[7] 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.

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[7] Sec. 420.

Excess assets generally means the excess, if any, of the value of the plan's assets[8] 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),[9] 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.

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 the 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 a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[10]

No qualified transfer may be made after December 31, 2005. Under present law, multiemployer plans are not eligible to make qualified transfers of excess defined benefit plan assets.

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

[9] These amounts represent 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.

[10] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

## Description of Proposal

The proposal allows the qualified transfers of excess defined benefit plan assets to be made by the defined benefit plan described in section 404(c) (or a continuation or spin-off thereof that primarily covers employees in the building and construction industry).

## Effective Date

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

## F. Retirement Account Portability Improvement

### 1. Rollovers by nonspouse beneficiaries

## Present Law

### Tax-free rollovers

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity "section 403(b) annuity"), an eligible deferred compensation plan of a State or local government employer (a "governmental section 457 plan"), or an individual retirement arrangement (an "IRA") generally is included in income for the year distributed. However, eligible rollover distributions may be rolled over tax free within 60 days to another plan, annuity, or IRA.[11]

In general, an eligible rollover distribution includes any distribution to the plan participant or IRA owner other than certain periodic distributions, minimum required distributions, and distributions made on account of hardship.[12] Distributions to a participant from a qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan generally can be rolled over to any of such plans or an IRA.[13] Similarly, distributions from an IRA to the IRA owner generally are permitted to be rolled over into a qualified retirement plan, a tax-sheltered annuity, a governmental section 457 plan, or another IRA.

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

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

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

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

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

**Minimum distribution rules**

Minimum distribution rules apply to tax-favored retirement arrangements. In the case of distributions prior to the death of the participant, distributions generally must begin by the April 1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70-1/2 or (2) retires.[14] The minimum distribution rules also apply to distributions following the death of the participant. If minimum distributions have begun prior to the participant's death, the remaining interest generally must be distributed at least as rapidly as under the minimum distribution method being used prior to the date of death. If the participant dies before minimum distributions have begun, then either (1) the entire remaining interest must be distributed within five years of the death, or (2) distributions must begin within one year of the death over the life (or life expectancy) of the designated beneficiary. A beneficiary who is the surviving spouse of the participant is not required to begin distributions until the date the deceased participant would have attained age 70-1/2. In addition, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, the minimum distribution rules apply separately to the surviving spouse.

## Description of Proposal

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

## Effective Date

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

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

**2. Faster vesting of employer nonelective contributions**

**Present Law**

Under present law, in general, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.[15]

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

**Description of Proposal**

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

**Effective Date**

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

**3. Direct rollovers from retirement plans to Roth IRAs**

**Present Law**

**IRAs in general**

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

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

## Traditional IRAs

An individual may make deductible contributions to an IRA up to the lesser of a dollar limit (generally $3,000 for 2003)[16] or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.[17] If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year. A different, higher, income phaseout applies in the case of an individual who is not an active participant in an employer sponsored plan but whose spouse is.

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

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

## Roth IRAs

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

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

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax

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

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

(unless an exception applies). The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

**<u>Rollover contributions</u>**

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

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

## <u>Description of Proposal</u>

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

## <u>Effective Date</u>

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

### 4. SIMPLE plan distribution rules

## <u>Present Law</u>

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers who employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year and who do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA") for each employee or part of a qualified cash or deferred arrangement (a "401(k) plan").[18] The rules applicable to SIMPLE IRAs and SIMPLE 401(k) plans are similar, but not identical.

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[18] Because State or local governments generally are not permitted to maintain 401(k) plans, they also generally are not permitted to maintain SIMPLE 401(k) plans. However, a State

If established in IRA form, a SIMPLE plan is not subject to the nondiscrimination rules generally applicable to qualified retirement plans (including the top-heavy rules) and simplified reporting requirements apply. If established as part of a 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules apply to SIMPLE 401(k) plans.

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

If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan may roll over distributions from the plan or annuity into an IRA. In addition, distributions from an IRA may generally be rolled over to another IRA, a qualified retirement plan, a tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan. However, limitations apply on rollovers between a SIMPLE IRA and one of these other retirement plans.

**Description of Propsosal**

The proposal eliminates the 25-percent early withdrawal tax on withdrawals of SIMPLE IRA contributions during the two-year period beginning on the date the employee first participated in the SIMPLE IRA. Thus, such withdrawals are subject to the 10-percent early withdrawal tax.

The proposal also allows rollovers from any type of tax-favored retirement plan to a SIMPLE IRA and from a SIMPLE IRA to any type of tax-favored retirement plan.

**Effective Date**

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

### 5. Certain rollovers of benefits allowed

**Present Law**

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

Amounts deferred under an eligible deferred compensation plan of a non-governmental tax-exempt organization are includible in gross income for the year in which amounts are paid or made available. Under present law, if the amount payable to a participant does not exceed

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

$5,000, a plan may allow a distribution up to $5,000 without such amount being treated as made available if the distribution can be made only if no amount has been deferred under the plan by the participant during the two-year period ending on the date of the distribution and there has been no prior distribution under the plan. Prior to the Small Business Job Protection Act of 1996, under former section 457(e)(9), benefits were not treated as made available because a participant could elect to receive a lump sum payable after separation from service and within 60 days of the election if (1) the total amount payable under the plan did not exceed $3,500 and (2) no additional amounts could be deferred under the plan.

**Description of Proposal**

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

**Effective Date**

The proposal is effective on the date of enactment.

### 6. Benefit transfers to the PBGC

**Present Law**

**Involuntary distributions and automatic rollovers**

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant (an "involuntary distribution") and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000.[19] Generally, a participant may roll over an involuntary distribution from a qualified plan to an individual retirement arrangement (an "IRA") or to another qualified plan.

In the case of an involuntary distribution that exceeds $1,000 and that is an eligible rollover distribution from a qualified retirement plan, the plan administrator must roll the distribution over to an IRA (an "automatic rollover") in certain cases.[20] That is, the plan administrator must make a direct trustee-to-trustee transfer of the distribution to an IRA, unless

[19] 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.

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

the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

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

**Missing participant benefits**

In the case of a defined benefit pension plan that is subject to the plan termination insurance program under Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA"), is maintained by a single employer, and terminates under a standard termination, the plan administrator generally must purchase annuity contracts from a private insurer to provide 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.[21]

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

## Description of Proposal

**Automatic rollovers**

The proposal provides an alternative to the automatic rollover to an IRA of an involuntary distribution that exceeds $1,000. Under the proposal, unless the participant elects to have the distribution transferred to an IRA or a qualified retirement plan or to receive it directly, the plan may provide for the transfer of the distribution to the PBGC, instead of to an IRA.[22] The written explanation provided to the participant by the plan administrator before the involuntary distribution must explain that a transfer to the PBGC will be made unless the participant elects otherwise.

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

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

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

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

### Effective Date

The proposal is effective as if included in the amendments made by section 657 of EGTRRA, i.e., after the issuance of final regulations by the Department of Labor.

## G. Fiduciary Rules for Plan Sponsors Designating Independent Investment Advisors

### Present Law

ERISA requires an employee benefit plan to provide for one or more named fiduciaries who jointly or severally have the authority to control and manage the operation and administration of the plan. In addition to fiduciaries named in the plan, or identified pursuant to a procedure specified in the plan, a person is a plan fiduciary under ERISA to the extent the fiduciary exercises any discretionary authority or control over management of the plan or exercises authority or control over management or disposition of its assets, renders investment advice for a fee or other compensation, or has any discretionary authority or responsibility in the administration of the plan. In certain circumstances, a fiduciary under ERISA may be liable for a breach of responsibility by a co-fiduciary.

### Description of Proposal

#### In general

The proposal amends ERISA by adding specific rules dealing with the provision of investment advice to plan participants by a qualified investment adviser. The proposal applies to an individual account plan[23] that permits a participant or beneficiary to exercise investment control over the assets in his or her account. Under the proposal, if certain requirements are met, an employer or other plan fiduciary will not be liable for investment advice provided by a qualified investment adviser.

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

**Qualified investment adviser**

Under the proposal, a "qualified investment adviser" is defined as a person who is a plan fiduciary by reason of providing investment advice and who is also (1) a registered investment adviser under the Investment Advisers Act of 1940 or registered as an investment adviser under the laws of the State (consistent with section 203A of the Investment Advisers Act[24]) in which the adviser maintains its principal office, (2) a bank or similar financial institution, (3) an insurance company qualified to do business under State law, or (4) a comparably qualified entity under criteria to be established by the Secretary of Labor. In addition, any individual who provides investment advice to participants on behalf of the investment adviser (such as an employee thereof) is required to be (1) a registered investment adviser under Federal or State law as described above,[25] (2) a registered broker or dealer under the Securities Exchange Act, (3) a registered representative under the Securities Exchange Act or the Investment Advisers Act, or (4) any comparably qualified individual under criteria to be established by the Secretary of Labor.

A qualified investment adviser is required to provide the following documents to the employer or plan fiduciary: (1) the contract for investment advice services, (2) a disclosure of the fees to be received by the investment adviser for the provision of investment advice or as a result of a participant's investment choices, and (3) documentation that the investment advisor is a qualified investment adviser. A qualified investment adviser that acknowledges its fiduciary status will be a fiduciary under ERISA with respect to investment advice provided to a participant or beneficiary.

**Requirements for employer or other fiduciary**

Before designating the investment adviser and at least annually thereafter, the employer or other fiduciary is required to obtain written verification that the investment adviser (1) is a qualified investment adviser, (2) acknowledges its status as a plan fiduciary that is solely responsible for the investment advice it provides, (3) has reviewed the plan document (including investment options) and determined that its relationship with the plan and the investment advice provided to any participant or beneficiary, including the receipt of fees or compensation, will not violate the prohibited transaction rules, (4) will consider any employer securities or employer real property allocated to the participant's or beneficiary's account in providing investment advice, and (5) has the necessary insurance coverage (as determined by the Secretary of Labor) for any claim by a participant or beneficiary.

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[24] *See*, 15 U.S.C. 80b-3a. Nothing in the proposal is intended to restrict the authority under present law of any State to assert jurisdiction over investment advisers and investment adviser representatives based on their presence in the State or the fact that they have clients in the State.

[25] An individual who is registered as an investment adviser under the laws of a State is a qualified investment adviser only if the State has an examination requirement to qualify for such registration.

In designating an investment adviser, the employer or other fiduciary is required to review the documents provided by the qualified investment adviser. The employer or other fiduciary is also required to make a determination that there is no material reason not to engage the investment adviser.

In the case of (1) information that the investment adviser is no longer qualified or (2) concerns about the investment adviser's services raised by a substantial number of participants or beneficiaries, the employer or other fiduciary is required within 30 days to investigate and to determine whether to continue the investment adviser's services.

An employer or other fiduciary that complies with the requirements for designating and monitoring an investment adviser will be deemed to have satisfied its fiduciary duty in the prudent selection and periodic review of an investment adviser and does not bear liability as a fiduciary or co-fiduciary for any loss or breach resulting from the investment advice.

### Effective Date

The proposal applies to investment advisers designated after the date of enactment of the proposal.

## H. Employer-Provided Qualified Retirement Planning Services

### Present Law

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes.[26] These excludable fringe benefits include qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified employer plan. A qualified employer plan includes a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, a SIMPLE retirement account, or a governmental plan, including an eligible deferred compensation plan maintained by a governmental employer.

Qualified retirement planning services are retirement planning advice and information. The exclusion is not limited to information regarding the qualified employer plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.

[26] Secs. 132 and 3121(a)(20).

## Description of Proposal

The proposal permits employers to offer employees a choice between cash compensation and eligible qualified retirement planning services. The maximum amount for which such a choice can be provided is limited to $1,000 per individual, per year. The proposal only applies to qualified retirement planning services provided by a qualified investment adviser. It is intended that qualified investment advisers are certified and regulated under applicable laws and regulations. In addition, qualified investment advisers also include investment advisers within a financial institution's trust or custody department chartered under the National Bank Act.[27] As under present law, the proposal applies only to amounts for retirement planning advice and information and does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

Under the proposal, no amount is includible in gross income or wages merely because the employee is offered the choice of cash in lieu of eligible qualified retirement planning services. Also, no amount is includible in income or wages merely because the employee is offered a choice among eligible qualified retirement planning services. The amount of cash offered is includible in income and wages only to the extent the employee elects cash. The exclusion does not apply to highly compensated employees unless the salary reduction option is available on substantially the same terms to all employees normally provided education and information about the plan.

Under the proposal, salary reduction amounts used to provide eligible qualified retirement planning services are generally treated for pension plan purposes the same as other salary reduction contributions. Thus, such amounts are included for purposes of applying the limits on contributions and benefits, and an employer is able to elect whether or not to include such amounts in compensation for nondiscrimination testing.

## Effective Date

The proposal is effective for taxable years beginning after December 31, 2003, and before December 31, 2008.

# I. Temporary Exclusion for Group Legal Services Benefits

## Present Law

For taxable years beginning before July 1, 1992, certain amounts contributed by an employer to a qualified group legal services plan for an employee (or the employee's spouse or dependents) or the value or legal services provided (or amounts paid for legal services) under such a plan with respect to an employee (or the employee's spouse or dependents) are excludable from an employee's gross income for income and employment tax purposes.[28] The exclusion is limited to an annual premium value of $70.

[27] 12 U.S.C. 92(a).

[28] Sec. 120.

Additionally, for taxable years beginning before July 1, 1992, an organization the exclusive function of which is to provide legal services or indemnification against the cost of legal services as part of a qualified group legal services plan is exempt from tax.[29]

## Description of Proposal

The proposal restores the exclusion for employer-provided group legal services for taxable years beginning after December 31, 2003, and before December 31, 2004. The amount of the exclusion is not limited.

Additionally, for taxable years beginning after December 31, 2003, and before December 31, 2004, the proposal provides tax-exempt status for organizations which provide qualified group legal services.

## Effective Date

The proposal applies to taxable years beginning after December 31, 2003, and before December 31, 2004.

# J. Extension of Provision Permitting Qualified Transfers of Excess Pension Assets to Retiree Health Accounts

## 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.[30] 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.

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[29] Sec. 501(c)(20).

[30] Sec. 420.

Excess assets generally means the excess, if any, of the value of the plan's assets[31] 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),[32] 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.

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 the 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 a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, the Employee Retirement Income Security Act of 1974 ("ERISA") provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.[33]

Under present law, multiemployer plans are not eligible to make qualified transfers of excess defined benefit plan assets. No qualified transfer may be made after December 31, 2005.

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

[32] These amounts represent 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.

[33] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

## Description of Proposal

The proposal allows qualified transfers of excess defined benefit plan assets through December 31, 2013.

## Effective Date

The proposal is effective on the date of enactment.

## K. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies

## Present Law

A property and casualty insurance company is eligible to be exempt from Federal income tax if its net written premiums or direct written premiums (whichever is greater) for the taxable year do not exceed $350,000 (sec. 501(c)(15)).

A property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) for the taxable year exceed $350,000, but do not exceed $1.2 million (sec. 831(b)).

For purposes of determining the amount of a company's net written premiums or direct written premiums under these rules, premiums received by all members of a controlled group of corporations of which the company is a part are taken into account. For this purpose, a more-than-50-percent threshhold applies under the vote and value requirements with respect to stock ownership for determining a controlled group, and rules treating a life insurance company as part of a separate controlled group or as an excluded member of a group do not apply (secs. 501(c)(15), 831(b)(2)(B) and 1563).

## Description of Proposal

The proposal modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, and to elect to be taxed only on taxable investment income.

Under the proposal, a property and casualty insurance company is eligible to be exempt from Federal income tax if (a) its gross receipts for the taxable year do not exceed $600,000, and (b) the premiums received for the taxable year are greater than 50 percent of its gross receipts. For purposes of determining gross receipts, the gross receipts of all members of a controlled group of corporations of which the company is a part are taken into account. The proposal expands the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

A company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax under the proposal. For this purpose, the term "insurance company" means any company, more than half of the business of which during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies (sec. 816(a)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.[34] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15).

The proposal also provides that a property and casualty insurance company may elect to be taxed only on taxable investment income if its net written premiums or direct written premiums (whichever is greater) do not exceed $1.2 million (without regard to whether such premiums exceed $350,000) (sec. 831(b)). As under present law, for purposes of determining the amount of a company's net written premiums or direct written premiums under this rule, premiums received by all members of a controlled group of corporations (as defined in section 831(b)) of which the company is a part are taken into account.

It is intended that regulations or other Treasury guidance provide for anti-abuse rules so as to prevent improper use of the provision, including, for example, by attempts to characterize as premiums any income that is other than premium income.

## Effective Date

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

## L. Determination of Basis Amounts Paid from Foreign Pension Plans

### Present Law

Distributions from retirement plans are includible in gross income under the rules relating to annuities[35] and, thus, are generally includible in income, except to the extent the amount received represents investment in the contract (i.e., the participant's basis). The participant's basis includes amounts contributed by the participant, together with certain amounts contributed by the employer, minus the aggregate amount (if any) previously distributed to the extent that such amount was excludable from gross income. Amounts contributed by the employer are included in the calculation of the participant's basis to the extent that such amounts were includible in the gross income of the participant, or to the extent that such amounts would have been excludable from the participant's gross income if they had been paid directly to the participant at the time they were contributed.

Distributions received by nonresidents from U.S. qualified plans and similar arrangements are generally subject to tax to the extent that the amount received is otherwise includible in gross income (i.e., is in excess of the basis) and is from a U.S. source. Employer contributions to qualified plans and other payments for services performed outside the United States generally are not treated as income from a U.S. source, and therefore generally are not subject to U.S. tax.

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[34] *See, e.g., Inter-American Life Insurance Co. v. Comm'r*, 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972).

[35] Sections 72 and 402.

Under the 1996 U.S. model income tax treaty and many U.S. income tax treaties in force, pension distributions beneficially owned by a resident of a treaty country in consideration for past employment generally are taxable only by the individual recipient's country of residence.[36] Under the 1996 U.S. model income tax treaty and some U.S. income tax treaties, this exclusive residence-based taxation rule is limited to the taxation of amounts that were not previously included in taxable income in the other country. For example, if a treaty country had imposed tax on a resident individual with respect to some portion of a pension plan's earnings, subsequent distributions to a resident of the other country would not be taxable in that country to the extent the distributions were attributable to such amounts.

## Description of Proposal

Under the proposal, an amount distributed from a foreign pension plan is included in the calculation of the recipient's basis only to the extent that the recipient previously has been subject to taxation, either in the United States or the foreign jurisdiction, on such amount.

## Effective Date

The proposal is effective for distributions occurring on or after the date of enactment.

[36] Some treaties permit source-country taxation but merely reduce the rate of tax imposed on pension benefits.