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108TH CONGRESS 2d Session | SENATE | REPORT 108–266

# NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT

MAY 14, 2004.—Ordered to be printed

Mr. GRASSLEY, from the Committee on Finance, submitted the following

# REPORT

together with

ADDITIONAL VIEWS

[To accompany S. 2424]

The Committee on Finance, having considered an original bill (S. 2424) to amend the Internal Revenue Code of 1986 and the Employee Retirement Income Security Act of 1974 to protect the retirement security of American workers by ensuring that pension assets are adequately diversified and by providing workers with adequate access to, and information about, their pension plans, and for other purposes, reports favorably thereon and recommends that the bill do pass.

CONTENTS



29–010

## I. LEGISLATIVE BACKGROUND

*Overview*

The Senate Committee on Finance marked up an original bill, the "National Employee Savings and Trust Equity Guarantee Act," on September 17, 2003, and ordered the bill favorably reported by voice vote. On October 1, 2003, the Finance Committee by unanimous consent recalled the bill and amended it to make the company-owned life insurance ("COLI") provision effective on date of enactment instead of date of committee action and agreed to a further markup of the COLI and related provisions of the bill. On February 2, 2004, the Committee marked up a modification to the bill and ordered the bill favorably reported by voice vote.

*Recent legislation*

The bill as approved by the Committee contained several provisions that are identical or substantially similar to provisions in recently enacted legislation and therefore are not contained in the bill as reported.

The Pension Equity Funding Act of 2004[1] contains provisions relating to:

- Two-year extension of transition rule to pension funding requirements;
- Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts;

[1] Pub. L. No. 108–218 (April 10, 2004). The Pension Equity Funding Act of 2004 also includes provisions relating to issues that are addressed by provisions in the bill, including the interest rate used for certain pension purposes and relief from the deficit reduction contribution requirements.

- Extension of provision permitting qualified transfers of excess pension assets to retiree health accounts;
- Modification of qualification rules for tax-exempt property and casualty insurance companies; and
- Definition of insurance company for property and casualty insurance company tax rules.

The Social Security Protection Act of 2004[2] contains a provision allowing Social Security coverage under a divided retirement system for public employees in Kentucky.

*Hearings*

During the 108th Congress, the Committee held hearings on various topics relating to the provisions of the bill, as follows.

The Committee held a hearing on April 8, 2003, on compensation-related issues addressed in the Joint Committee on Taxation staff investigation and report relating to Enron Corporation. The Committee also held a hearing on March 11, 2003, on issues relating to the funding of defined benefit plans.

The Committee held a hearing on COLI on October 23, 2003.

*Activity during the 107th Congress*

During the 107th Congress, the Committee reported a bill, S. 1971 (the "National Employee Savings and Trust Equity Guarantee Act"), which addressed many of the same issues addressed by the current bill. Many of the provisions in the current bill are substantially the same as those previously reported by the Committee in S. 1971 (107th Cong.)

During the 107th Congress, the Committee held hearings on various topics relating to the provisions of S. 1971 (107th Cong.). The Committee held a hearing on February 27, 2002, regarding retirement security. The Committee also held a hearing on April 18, 2002, regarding corporate governance and executive compensation.

# II. EXPLANATION OF THE BILL

## TITLE I. DIVERSIFICATION OF PENSION PLAN ASSETS

### A. Defined Contribution Plans Required To Provide Employees With Freedom To Invest Their Plan Assets

(Sec. 101 of the bill, new sec. 401(a)(35) of the Code, and new sec. 204(j) of ERISA)

#### 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 elec-

[2] Pub. L. No. 108–203 (March 2, 2004).

tive 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"),[3] 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 qualifying employer securities and that meets certain other requirements under the Code. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

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.[4]

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.[5] 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.

[3] 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.

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

[5] 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.

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).[6]

*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.[7] 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.[8] 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 pension plans and money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities or 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.[9] 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 employer real property in a defined contribution plan.[10]

The 10–percent limitation on the acquisition of employer securities and real property applies separately to the portion of a plan

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

[7] ERISA sec. 407.

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

[9] 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 pension plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

[10] 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."

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.

REASONS FOR CHANGE

Recent events have focused public attention on the investment of retirement plan assets in employer securities. The bankruptcies of several large publicly-traded companies, such as the Enron Corporation, have been accompanied by the loss of employees' pension benefits because defined contribution plan assets were heavily invested in employer securities. In many cases, employees lost not only their jobs, but also their retirement savings, upsetting their plans for retirement.

The Committee understands that employer securities are one possible investment for defined contribution plans. In some cases, the plan may offer employer securities as one of several investment options made available to plan participants. In other cases, the plan may provide that certain contributions are invested in employer securities. For example, many plans provide that employer matching contributions with respect to employee elective deferrals under a qualified cash or deferred arrangement are to be invested in employer securities.

Present law has facilitated and encouraged the acquisition of employer securities by defined contribution plans, particularly in the case of ESOPs. Thus, for example, present law provides that the dividends paid on employer securities held by an ESOP are deductible under certain circumstances and also allows an ESOP to borrow to acquire the employer securities. Present law recognizes that employer securities can be a profitable investment for employees as well as a corporate financing tool for employers. Employees who hold employer securities through a defined contribution plan often feel that they have a stake in the business, leading to increased profitability.

On the other hand, the Committee recognizes that diversification of assets is a basic principle of sound investment policy and that requiring certain contributions to be invested in employer securities may create tension with the objectives of diversification. Failure to adequately diversify defined contribution plan investments may jeopardize retirement security. The Committee believes that participants should be provided with a greater opportunity to diversify plan investments in employer securities.

In addition, at the request of the Committee, the staff of the Joint Committee on Taxation ("Joint Committee staff") undertook an investigation relating to Enron Corporation and related entities, including a review of the compensation arrangements of Enron employees, e.g., qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements. The Joint Committee staff issued an official report of its investigation,[11] including findings and recommendations resulting from its review of Enron's pension plans and compensation arrangements. The Joint Committee staff's findings support the Committee's views regarding the need for greater diversification in the investment of defined contribution plan assets. The Joint Committee staff found that participants in Enron's Savings Plan lost considerable amounts of retirement savings due to the high level of investment in Enron stock and that Enron's plan is not alone in its high concentration of investment in employer stock.[12] The Joint Committee staff recommended legislative changes to allow participants greater opportunities to invest their accounts in diversified investments, rather than in employer securities.[13]

The Committee believes that allowing participants greater opportunity to diversify plan investments in employer securities will help participants achieve their retirement security goals, while continuing to allow employers and employees the freedom to choose their own investments. The Committee bill therefore requires certain defined contribution plans that hold employer securities that are publicly traded to permit plan participants to direct the plan to reinvest employer securities in other assets. The Committee bill generally requires diversification in accordance with the present-law rules regarding vesting.

Recent issues relating to investments in employer securities have arisen in the context of publicly-traded companies. Although similar issues may arise with respect to investments in employer securities by retirement plans of privately-held companies, the Committee understands that such investments often play a different role than in the case of publicly-traded companies. For example, it is more common for an ESOP of a privately-held company to hold a controlling interest in the employer. In addition, because of the lack of a public market for the securities, diversification could put an undue financial strain on the employer. Thus, the diversification requirements in the bill apply only to defined contribution plans holding employer securities of publicly traded companies.

The Committee believes that the current role of ESOPs should be preserved in order to encourage this form of ownership. Thus, the bill does not apply additional diversification requirements to "stand alone" ESOPs, meaning ESOPs that do not hold elective deferrals and related contributions. Again, the Committee believes this strikes an appropriate balance between the principle of diversification and the goals served by ESOPs.

Investment of defined contribution plan assets in employer real property may present similar issues as to adequate diversification, particularly if plan assets are also invested in employer securities. Accordingly, the diversification requirements apply to both employer securities and employer real property in the case of a plan that holds publicly-traded employer securities.

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[11] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

[12] Id. at Vol. I. 12–13, 39–40, 515–540.

[13] Id. at Vol. I, 19, 39–40, 538–540.

EXPLANATION OF PROVISION

*In general*

Under the provision, 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 provision, 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," [14] which means a defined contribution plan holding publicly-traded employer securities (i.e., securities issued by the employer or a member of the employer's controlled group of corporations [15] 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 [16] 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

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

[15] 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.

[16] 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.

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 provision. The diversification rights applicable under the provision 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.[17]

The diversification requirements under the provision 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.[18]

*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

[17] 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 provision or greater diversification rights than required under the provision.

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

years of service,[19] 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 provision 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 the new 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.

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 |
| Second year | 66 |
| Third year | 100 |

The application of the transition rule is illustrated by the following example. Suppose that the account of a participant with at least three years of service held 120 shares of employer common stock contributed as matching contributions before the diversification requirements became effective. In the first year for which diversification applies, 33 percent (i.e., 40 shares) of that stock is subject to the diversification requirements. In the second year for which diversification applies, a total of 66 percent of 120 shares of stock (i.e., 79 shares, or an additional 39 shares) is subject to the diversification requirements. In the third year for which diversification applies, 100 percent of the stock, or all 120 shares, is subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee after-tax contributions is fully subject to the diversification requirements, as is any new stock contributed to the account.

*Rules relating to the election of 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

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

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. For example, in the case of a plan that provides diversification rights with respect to investments in employer real property, if the property must be sold in order to implement an applicable individual's request to divest his or her account of employer real property, a longer period may be needed to implement the individual's request than the time needed to implement other investment changes. Providing a longer period is permissible in those circumstances.

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 provision 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 provision 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.

A special effective date applies 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 special 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. When the new diversification requirements become effective for the plan under the special rule, the applicable percentage of employer securities or employer real property held on the effective date that is subject to diversification is determined without regard to the special rule. For example, if, under the general effective date, the diversification requirements would first apply to the plan for the first plan year beginning after December 31, 2003, and, under the special rule, the diversification requirements first apply to the plan for the first plan year beginning after December 31, 2006, the applicable percentage for that year is 100 percent.

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

(Sec. 102 of the bill, new sec. 4980H of the Code, and new sec. 104(d) of ERISA)

### 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 a day 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.

### REASONS FOR CHANGE

The bill provides participants with new rights to diversify the investment of their defined contribution plan accounts. After the new diversification requirements become effective, information about these rights will be provided to participants in accordance with present law, for example, as part of the summary plan description. However, under present law, such information is not required to be provided at the time the new diversification requirements become effective. Moreover, with respect to future participants, such information may be provided when an employee first becomes a participant in the plan, generally after one year of service, whereas, in some cases, a participant becomes eligible for diversification after three years of service. The Committee believes that participants should receive a specific notice of their diversification rights shortly before they first become eligible to exercise such rights. Such notice will better enable participants to exercise and benefit from the new diversification rights.

## EXPLANATION OF PROVISION

*In general*

The provision 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 provision of the bill. Not later than 30 days before the first date on which an applicable individual is eligible to exercise such right with respect to any type of contribution, 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. Under the diversification provision of the bill, an applicable individual's right to divest his or her account of employer securities or employer real property attributable to elective deferrals and employee after-tax contributions and the right to divest his or her account of employer securities or employer real property attributable to other contributions (i.e., nonelective employer contributions and employer matching contributions) may become exercisable at different times. Thus, to the extent the applicable individual is first eligible to exercise such rights at different times, separate notices are required.

The notice 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 applicable individual. The Secretary of Labor is directed to prescribe a model notice to be used for this purpose within 180 days of enactment of the provision.

*Sanctions for failure to provide notice*

*Excise tax*

Under the provision, 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.[20] 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 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.

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

*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 provision generally applies on the date of enactment of the provision. Under a transition rule, if notice under the provision would otherwise be required before 90 days after the date of enactment, notice is not required until 90 days after the date of enactment.

## TITLE II. INFORMATION TO ASSIST PENSION PLAN PARTICIPANTS

### A. PERIODIC PENSION BENEFIT STATEMENTS AND INVESTMENT EDUCATION

(Secs. 201–202 of the bill, new sec. 4980I of the Code, and sec. 104 and 105(a) of ERISA)

PRESENT LAW

*In general*

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan.[21] 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 a day 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. 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.

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

*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.

*Investment guidelines*

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

REASONS FOR CHANGE

The Committee believes that regular information concerning the value of retirement benefits, especially the value of benefits accumulating in a defined contribution plan account, is necessary to increase employee awareness and appreciation of the importance of retirement savings.

Under some employer-sponsored retirement plans, participants are responsible for directing the investment of the assets in their accounts under the plan. Awareness of investment principles, including the need for diversification, is fundamental to making investment decisions consistent with long-term retirement income security. The Committee believes participants should be provided with investment guidelines and information for calculating retirement income to enable them to make sound investment and retirement savings decisions.

At the request of the Committee, the Joint Committee staff undertook an investigation relating to Enron Corporation and related entities, including a review of the compensation arrangements of Enron employees, e.g., qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements. The Joint Committee staff issued an official report of its investigation,[22] including findings and recommendations resulting from its review of Enron's pension plans and compensation arrangements. The Joint Committee staff's findings support the Committee's views regarding participants' need for investment education. The Joint Committee staff found that significant amounts of plan assets were invested in Enron stock even though the plan offered approximately 20 other investment options.[23] The Joint Committee staff recommended legislative changes to require plans to provide participants with notices regarding investment principles and investment education.[24]

[22] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.
[23] Id. at Vol. I, 12, 522–523, 526–535, 536.
[24] Id. at Vol. I, 19, 39, 538.

EXPLANATION OF PROVISION

*Pension benefit statements*

*In general*

The provision 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. The benefit statement requirements do not apply to a one-participant retirement plan.[25]

*Requirements for defined contribution plans*

Under the provision, the administrator of a defined contribution plan 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.[26]

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 pension 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 provision 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 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). A quarterly benefit statement provided to a participant or beneficiary who has the right to direct investments must also provide: (1) an explanation of any limitations or restrictions on any right of the individual to direct an investment; 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.

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

[26] In the case of a tax-sheltered annuity (sec. 403(b)) that is not a plan established or maintained by the employer, the benefit statement generally must be provided by the issuer of the annuity contract.

### *Requirements for defined benefit pension plans*

Under the provision, the administrator of a defined benefit pension plan is 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 pension 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 pension 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 provision 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 provision, 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 provision, the administrator of a defined contribution plan (other than a one-participant retirement plan) 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.[27]

*Model form*

Under the provision, 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. For example, information on how investment fees may affect the return on an investment is appropriate other information that the Secretary may determine must be included in the investment guidelines.

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 value of the individual's vested benefits under the plan (expressed as an annuity amount and 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 annually 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

[27] In the case of a tax-sheltered annuity (sec. 403(b)) that is not a plan established or maintained by the employer, the model form generally must be provided by the issuer of the annuity contract.

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 provision, 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.[28] 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 applies 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 to furnish a benefit statement required under the provision. 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 provision, 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 provision contains an exception from the benefit statement and investment notice requirements under the Code for a govern-

[28] 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 generally imposed on the issuer of the annuity contract.

mental 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.

### EFFECTIVE DATE

The provision 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 provision 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

(Sec. 203 of the bill, new sec. 4980H of the Code, and secs. 104 and 502 of ERISA)

### 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 a day 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.

### REASONS FOR CHANGE

The Committee believes that, in the case of a defined contribution plan that allows participants and beneficiaries to exercise control over the assets in their individual accounts, the same material investment information that the plan sponsor is required to disclose to investors under securities laws should be provided to participants and beneficiaries whose accounts are invested in employer stock. The Committee believes that plan administrators should be required to provide this information.

EXPLANATION OF PROVISION

*In general*

The provision 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 provision 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*

*Excise tax*

Under the provision, 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.[29] The excise tax is $100 per day for each participant or beneficiary with respect to whom the failure occurs, until the information is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the 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 requirement. In addition, no tax is imposed if the employer exercises reasonable diligence to comply and provides the required information 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 provision, 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.

*Effective Date*

The provision 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

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

any extension thereof after the date of enactment), or (2) December 31, 2005.

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

(Sec. 204 of the bill and new sec. 404(e) of ERISA)

### 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.

### REASONS FOR CHANGE

The Committee believes that providing specific rules under which a fiduciary may arrange for independent investment advice to be provided to participants who are responsible for directing the investment of their retirement assets will facilitate the provision of such investment advice without undercutting the fiduciary requirements of ERISA. The provision of independent investment advice will better enable participants to make sound investment decisions.

### EXPLANATION OF PROVISION

*In general*

The provision amends ERISA by adding specific rules dealing with the provision of investment advice to plan participants by a qualified investment adviser. The provision applies to an individual account plan [30] that permits a participant or beneficiary to direct the investment of the assets in his or her account. Under the provision, if certain requirements are met, an employer or other plan fiduciary will not be liable for investment advice provided by a qualified investment adviser.

*Qualified investment adviser*

Under the provision, 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 [31]) in which the adviser

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

[31] See, 15 U.S.C. 80b–3a. Nothing in the provision 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.

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,[32] (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 any fees or other compensation to be received by the investment adviser for the provision of investment advice and any fees or other compensation to be received as a result of a participant's investment choices, and (3) its registration with the Securities and Exchange Commission or other documentation of its status as 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.

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

[32] 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.

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 provision applies to investment advisers designated after the date of enactment of the provision.

## D. Employer-Provided Qualified Retirement Planning Services

(Sec. 205 of the bill and sec. 132 of the Code)

PRESENT LAW

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes.[33] 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.

REASONS FOR CHANGE

The Committee believes that it is important for all employees to have access to retirement planning advice and information. In order to plan adequately for retirement, individuals must anticipate retirement income needs and understand how their retirement income goals can be achieved. The Committee believes that allowing employees to purchase qualified retirement planning services on a salary-reduction basis will help many more employees obtain advice and assistance when making retirement decisions.

EXPLANATION OF PROVISION

The provision permits employers to offer employees a choice between cash compensation and eligible qualified retirement planning

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

services. The maximum amount for which such a choice can be provided is limited to $1,000 per individual, per year. The provision only applies to qualified retirement planning services provided by an eligible investment adviser.

Under the provision, an "eligible investment adviser" is defined as a person who is (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 [34]) 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 the Treasury. 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,[35] (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 the Treasury.

As under present law, the provision 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 provision, 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 provision, 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 in compensation 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 provision is effective for taxable years beginning after December 31, 2004, and before January 1, 2010.

[34] See, 15 U.S.C. 80b–3a.

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

## TITLE III. PROTECTION OF PENSION PLAN PARTICIPANTS

### A. NOTICE TO PARTICIPANTS OR BENEFICIARIES OF BLACKOUT PERIODS

(Sec. 301 of the bill, new sec. 4980J of the Code, and sec. 101(i) of ERISA)

PRESENT LAW

*In general*

The Sarbanes-Oxley Act of 2002[36] amended ERISA to require that the plan administrator of an individual account plan[37] provide advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.[38] 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.[39]

*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 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 modifica-

[36] Pub. L. No. 107–204 (2002).

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

[38] 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.

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

tions 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 the case of a failure to provide notice of a significant reduction in benefit accruals, an excise tax of $100 a day 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.

REASONS FOR CHANGE

In the course of normal plan operation, periods may occur during which a plan participant's ability to direct the investment of his or her account or obtain loans or distributions from the plan is restricted (a so-called "blackout" period). These periods usually occur in connection with administrative changes, such as a change in recordkeepers or in the investment options offered under a plan. Such a period may result also from changes in the plan in connection with a corporate transaction, such as a sale or merger. Present law requires advance notice of a blackout period to plan participants and beneficiaries to whom the blackout period applies. The Committee believes that such blackout notices serve an important purpose by allowing plan participants to prepare for any restrictions that will occur during a blackout period. The Committee believes that modifying the blackout notice requirement to better match plan operations will improve the notices. Additionally, enhancing enforcement of the blackout notice requirement will ensure that all participants receive blackout notices, and thus, have the opportunity to prepare for any restrictions that will occur during a blackout period.

At the request of the Committee, the Joint Committee staff undertook an investigation relating to Enron Corporation and related entities, including a review of the compensation arrangements of Enron employees, e.g., qualified retirement plans, nonqualified deferred compensation arrangements, and other arrangements. The Joint Committee staff issued an official report of its investigation,[40] including findings and recommendations resulting from its review of Enron's pension plans and compensation arrangements. The Joint Committee staff found that Enron provided a variety of advance notices to plan participants explaining the proposed blackout; however, the Joint Committee staff determined that not all participants received the same notices. In particular, certain active employees received additional reminders of the blackout that were

[40] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

not sent to other participants.[41] The Joint Committee staff's findings support the Committee's views regarding the need for plan participants to receive notice of blackouts sufficient to allow them to make appropriate decisions in anticipation of a blackout.

EXPLANATION OF PROVISION

*In general*

The provision amends the Code to include a blackout notice requirement similar to the present law ERISA requirement and makes certain modifications to the ERISA notice requirement. The blackout notice requirement under the Code does not apply to a one-participant retirement plan, a governmental plan, or a church plan.[42]

*Definition of blackout period*

The provision 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 retirement plan*

The provision clarifies the definition of a one-participant retirement plan not subject to the blackout notice requirement. Under the provision, for purposes of the blackout notice requirements under the Code and ERISA, the definition is conformed to the definition that applies under the provision 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 provision, an excise tax is generally imposed on the employer if a blackout notice is not provided as required under the Code.[43] 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 rea-

[41] Id. at Vol. I, 12–13, 38–38, 493–515.

[42] In the case of a tax-sheltered annuity (sec. 403(b)) that is not a plan established or maintained by the employer, the blackout notice generally must be provided by the issuer of the annuity contract.

[43] 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 excise tax generally is imposed on the issuer of the annuity contract.

sonable 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.

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 provision are effective as if included in section 306 of the Sarbanes-Oxley Act of 2002.

## TITLE IV. OTHER PROVISIONS RELATING TO PENSIONS

### A. PROVISIONS RELATING TO PENSION PLAN FUNDING

1. Replacement of interest rate on 30–year Treasury securities used for certain pension plan purposes (secs. 401–408 of the bill, secs. 401(a)(36), 404, 412, 415(b), and 417(e) of the Code, and secs. 205(g), 206, 302, and 4006 of ERISA)

PRESENT LAW [44]

*In general*

Under present law, the interest rate on 30-year Treasury securities is used for several purposes related to defined benefit pension plans. Specifically, the interest rate on 30-year Treasury securities is used: (1) in determining current liability for purposes of the funding and deduction rules; (2) in determining unfunded vested benefits for purposes of Pension Benefit Guaranty Corporation ("PBGC") variable rate premiums; and (3) in determining the minimum required value of lump-sum distributions from a defined benefit pension plan and maximum lump-sum values for purposes of the limits on benefits payable under a defined benefit pension plan.

The IRS publishes the interest rate on 30-year Treasury securities 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.

[44] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Pension Funding Equity Act of 2004 ("PFEA 2004"), Pub. L. No. 108–218 (April 10, 2004). Section 101 of PFEA 2004 changes the interest rates used for certain pension purposes for 2004 and 2005. Specifically, it provides for the use of an interest rate based on amounts invested conservatively in long-term corporate bonds for purposes of determining current liability and PBGC variable rate premiums for plan years beginning in 2004 and 2005. In addition, in the case of plan years beginning in 2004 or 2005, in applying the limits on benefits payable under a defined benefit pension plan to certain forms of benefit, such as a lump sum, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan. Under section 102 of PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules apply for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

*Funding rules*

*In general*

The Internal Revenue Code (the "Code") and the Employee Retirement Income Security Act of 1974 ("ERISA") impose minimum funding requirements with respect to defined benefit pension plans.[45] Under the 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 special funding rules (referred to as the "deficit reduction contribution" rules),[46] an additional contribution to a plan is generally required if the plan's funded current liability percentage is less than 90 percent.[47] A plan's "funded current liability percentage" is the actuarial value of plan assets[48] 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.

The amount of the additional contribution required under the deficit reduction contribution rules is the sum of two amounts: (1) the excess, if any, of (a) the deficit reduction contribution (as described below), over (b) the contribution required under the normal funding rules; and (2) the amount (if any) required with respect to unpredictable contingent event benefits.[49] The amount of the additional contribution cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

The deficit reduction contribution is the sum of (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[50] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded cur-

[45] Code sec. 412; ERISA sec. 302. The Code also imposes limits on deductible contributions, as discussed below.

[46] The deficit reduction contribution rules apply 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 these rules.

[47] Under an alternative test, a plan is not subject to the deficit reduction contribution rules 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.

[48] The actuarial value of plan assets is the value determined under an actuarial valuation method that takes into account fair market value and meets certain other requirements. The use of an actuarial valuation method allows appreciation or depreciation in the market value of plan assets to be recognized gradually over several plan years. Sec. 412(c)(2); Treas. reg. sec. 1.412(c)(2)–1.

[49] A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. An additional contribution is generally not required with respect to unpredictable contingent event benefits unless the event giving rise to the benefits has occurred.

[50] If the Secretary of the Treasury prescribes a new mortality table to be used in determining current liability, as described below, the deficit reduction contribution may include an additional amount.

rent liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but is reduced if the plan's funded current liability percentage is greater than 60 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 to determine a plan's current liability must be within a permissible range of the weighted average[51] 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.[52] 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.[53]

The Job Creation and Worker Assistance Act of 2002[54] 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.

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.[55] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[56]

*Full funding limitation*

No contributions are required under the minimum funding rules in excess of the full funding limitation. In 2004 and thereafter, the full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.[57] However, the full funding limitation may not be less than

[51] 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. Notice 88–73, 1988–2 C.B. 383.

[52] 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.

[53] Code sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II). Under Notice 90–11, 1990–1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

[54] Pub. L. No. 107–147.

[55] Code sec. 412(l)(7)(C)(ii); ERISA sec. 302(d)(7)(C)(ii).

[56] Rev. Rul. 95–28, 1995–1 C.B. 74. The IRS and the Treasury Department have announced that they are undertaking a review of the applicable mortality table and have requested comments on related issues, such as how mortality trends should be reflected. Notice 2003–62, 2003–38 I.R.B. 576; Announcement 2000–7, 2000–1 C.B. 586.

[57] For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (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, but in no case less than the excess, if any, of 90 percent of the

the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

*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.[58] 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.[59]

*Funding waivers*

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[60] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan. In addition, the IRS is authorized to require security to be granted as a condition of granting a funding waiver if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

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plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

[58] Code sec. 412(m); ERISA sec. 302(e).

[59] 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 purposes of applying the quarterly contributions requirements to plan years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability 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.

[60] Code sec. 412(d); ERISA sec. 303.

*Excise tax*

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[61] The excise tax is generally 10 percent of the amount of the funding deficiency. In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period.

*Deductions for contributions*

Employer contributions to qualified retirement plans are deductible, subject to certain limits. In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.[62] However, the maximum amount of deductible contributions is generally not less than the plan's unfunded current liability.[63]

*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 PBGC generally insures the benefits owed under defined benefit pension plans (up to certain limits) in the event a 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.[64] In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the annual yield 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 annual yield 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 pension 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 pension plans generally provide that a participant may choose among other forms of benefit offered under the

[61] Code sec. 4971.
[62] Code sec. 404(a)(1).
[63] Code sec. 404(a)(1)(D). 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 (sometimes referred to as "termination liability").
[64] ERISA sec. 4006.

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 pension 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.[65] 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 rate of interest 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 pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $165,000 (for 2004).[66] The dollar limit generally applies to a benefit payable in the form of a straight life annuity beginning no earlier than age 62. The limit is reduced if benefits are paid before age 62. In addition, if the benefit is not in the form of a straight life annuity, the benefit generally is adjusted to an equivalent straight life annuity. In making these reductions and adjustments, the interest rate used generally must be not less than the greater of: (1) five percent; or (2) the interest rate specified in the plan. However, for purposes of adjusting a benefit in a form that is subject to the minimum value rules (including the use of the interest rate on 30-year Treasury securities), such as a lump-sum benefit, the interest rate used must be not less than the greater of: (1) the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan.

REASONS FOR CHANGE

The Treasury Department no longer issues 30–year Treasury securities, making it necessary to provide a replacement rate for pension purposes. The Committee considers interest rates on high-quality corporate bonds to be an appropriate replacement. However, the Committee believes that a more accurate calculation would result from matching interest rates to the timing of expected payments than using a single long-term interest rate. Accordingly,

[65] Code sec. 417(e)(3); ERISA sec. 205(g)(3).
[66] Code sec. 415(b).

a yield curve that reflects the rates of interest on corporate bonds of varying maturities should be used for pension purposes.

The Committee recognizes that a change in interest rates used to calculate lump sum payments to participants and beneficiaries must be phased in gradually so participants are not forced to make hasty decisions about the timing of retirement. A deferred effective date followed by a phase-in period for the yield curve would give participants adequate time to review the impact of the change in interest rates.

The Committee believes that the deficit reduction contribution rules play an important role in assuring that pension plans are adequately funded. However, in recent years, a combination of sharp declines in plan asset values and unusually low interest rates has resulted in large additional contribution requirements in the case of plans that were not previously subject to the deficit reduction contribution rules. Making such additional contributions may have the effect of diverting funds from other business uses, which could force some companies into bankruptcy or to consider freezing or terminating their pension plans, thereby further weakening the pension system and the financial status of the PBGC. The Committee thus believes that employers should be provided temporary relief from such additional contributions. The Committee also believes that the deductible contribution limit should be increased to allow plan sponsors to contribute more in good times and thereby be able to contribute less in bad times.

The Committee is also concerned about seriously underfunded plans maintained by employers experiencing ongoing financial uncertainty. Such plans present a risk to employees, as well as to the PBGC insurance program and to other PBGC premium payors. The Committee believes that appropriate restrictions should apply to limit the risk presented by such plans.

## EXPLANATION OF PROVISION

### *Interest rate used to determine current liability and PBGC premiums*

#### *In general*

The provision changes the interest rate used in determining current liability for funding and deduction purposes and in determining PBGC variable rate premiums for plan years beginning after December 31, 2003. The interest rate used for these purposes is based on rates of interest on high-quality corporate bonds. For plan years beginning before January 1, 2007, the interest rate is based on amounts invested in high-quality long-term corporate bonds. For subsequent years, interest rates are determined using a yield curve method that matches interest rates drawn from a yield curve based on high-quality corporate bonds with the timing of expected benefit payments under the plan. The yield curve method is phased in over five years.

#### *Current liability for 2004–2006*

For purposes of determining a plan's current liability for plan years beginning in 2004, 2005, and 2006, the interest rate used must be within a permissible range of the weighted average of conservative long-term corporate bond rates during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. For purposes of determining the four-year weighted average, the weighting applicable under present law applies (i.e., 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period).

The Secretary of the Treasury is directed to prescribe by regulation a method for periodically determining conservative long-term corporate bond rates for this purpose. The rates are to reflect rates of interest on amounts invested in high-quality long-term corporate bonds and are to be based on the use of one or more indices as determined from time to time by the Secretary. For this purpose, it is intended that high-quality corporate bonds are generally those in the top two quality levels available, but may include the third quality level as the Secretary deems appropriate.

*Current liability after 2006*

For plan years beginning after 2006, current liability is determined using the yield curve method, which is phased in over five years.

The yield curve method is a method under which current liability is determined: (1) using interest rates drawn from a yield curve prescribed by the Secretary of the Treasury that reflects interest rates on high-quality corporate bonds of varying maturities; and (2) by matching the timing of the expected benefit payments under the plan to the interest rates on the yield curve (i.e., for bonds with maturity dates comparable to the times when benefits are expected to be paid). The Secretary of the Treasury is directed to publish any yield curve prescribed under the provision and the method of determining the yield curve, including the period of time for which interest rates are taken into account in determining the yield curve and the frequency with which a new yield curve is prescribed. For example, the Secretary may prescribe the yield curve on a monthly basis, to be applied for plan years beginning in the following month.

Under the phase-in yield curve method applicable for plan years beginning in 2007–2010, current liability for a plan year equals the sum of two amounts: (1) the applicable percentage of current liability determined under the yield curve method; and (2) current liability determined using an interest rate in the permissible range of the weighted four-year average of conservative long-term corporate bond rates (i.e., the interest rate applicable for plan years beginning in 2004–2006), multiplied by a percentage equal to 100 percent minus the applicable percentage for the plan year. For this purpose, the applicable percentage for a plan year is determined in accordance with the following table.

TABLE 2.—APPLICABLE PERCENTAGE FOR PLAN YEARS BEGINNING IN 2007–2010

| Plan years beginning in: | Applicable percentage |
|---|---|
| 2007 | 20 |
| 2008 | 40 |
| 2009 | 60 |
| 2010 | 80 |

Thus, for example, for plan years beginning in 2008, current liability under the phase-in yield curve method is the sum of: (1) 40 percent of current liability determined under the yield curve method, and (2) 60 percent of current liability determined using an interest rate in the permissible range of the weighted four-year average of conservative long-term corporate bond rates.

The Secretary of the Treasury is directed to prescribe one or more simplified methods, in lieu of the yield curve method, for use in determining current liability. Such a simplified method may be used by a plan (other than a multiemployer plan) if, on each day during the preceding plan year, the plan had no more than 100 participants.[67] A simplified method may apply for purposes of both the yield curve method and the phase-in yield curve method.

*PBGC variable rate premiums*

For plan years beginning in 2004, 2005, or 2006, the interest rate used in determining the amount of unfunded vested benefits is the conservative long-term corporate bond rate (as determined by the Secretary of the Treasury) for the month preceding the month in which the plan year begins. For years after 2006, the interest rate or method applicable in determining current liability for a plan year also applies in determining the amount of unfunded vested benefits for the plan year for purposes of determining PBGC variable rate premiums. Thus, the phase-in yield curve method applies for plan years beginning in 2007 through 2010, and the yield curve method applies for plan years beginning after 2010. In addition, any simplified method prescribed by the Secretary of the Treasury may be used instead of the phase-in yield curve method or the yield curve method in determining the amount of unfunded vested benefits (without regard to the number of participants covered by the plan).

*Interest rate used to determine minimum lump-sum benefits*

For plan years beginning in 2007 through 2010, the phase-in yield curve method generally applies in determining the amount of a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, except that the annual rate of interest on 30-year Treasury securities is substituted for the conservative long-term corporate bond rate. Thus, for example, for plan years beginning in 2008, a lump-sum benefit payable under a plan may not be less than the sum of: (1) 40 percent of the minimum lump-sum benefit determined under the yield curve method, and (2) 60 percent of the minimum lump-sum benefit determined using the annual rate of interest on 30-year Treasury securities.

For plan years beginning after 2010, the yield curve method generally applies in determining the amount of a benefit in a form that is subject to the minimum value rules.

Any simplified method prescribed by the Secretary of the Treasury to be used instead of the yield curve method in determining current liability may also be used in determining minimum lump-sum benefits (without regard to the number of participants covered by the plan). It is intended that, for this purpose, the Secretary

[67] All defined benefit pension plans maintained by the same employer are treated as a single plan for this purpose.

may prescribe a factor to be used that combines the required interest rate and mortality assumptions applicable under the minimum value rules. If a plan provides for the use of a simplified method for purposes of calculating lump-sum benefits, the simplified method must apply consistently to all participants and to all lump sums. A plan may be amended to change the method used to determine lump-sum benefits (e.g., from the yield curve method to a simplified method or from one simplified method to another), subject to the anticutback rules generally prohibiting the elimination of optional forms of benefit, as well as the nondiscrimination rules regarding the timing of plan amendments.

Under the provision of the bill relating to plan amendments (sec. 471 of the bill), a plan amendment made pursuant to a provision of the bill generally will not violate the anticutback rule if certain requirements are met (e.g., the plan amendment is made on or before the last day of the first plan year beginning on or after January 1, 2006). Thus, subject to those requirements, a plan amendment will not violate the anticutback rule merely because it provides for the use of the phase-in yield curve method and the yield curve method, or a simplified method, rather than the interest rate on 30-year Treasury securities, in determining benefits subject to the minimum value rules.

*Interest rate used to apply benefit limits to lump sums*

Under the provision, in adjusting a form of benefit that is subject to the minimum value rules, such as a lump-sum benefit, for purposes of applying the limits on benefits payable under a defined benefit pension plan (sec. 415), the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.[68]

Under the provision of the bill relating to plan amendments (sec. 471 of the bill), a plan amendment made pursuant to a provision of the bill generally will not violate the anticutback rule if certain requirements are met (e.g., the plan amendment is made on or before the last day of the first plan year beginning on or after January 1, 2006). Thus, subject to those requirements, a plan amendment made pursuant to the provision relating to the interest rate used to apply the benefit limits to lump-sum benefits generally will not violate the anticutback rule.[69]

*Deficit reduction contribution relief*

Under the provision, if a plan was not subject to the deficit reduction contribution rules for the plan year beginning in 2000, the deficit reduction contribution rules do not apply to the plan for plan years beginning in 2004, 2005, or 2006.[70] Thus, with respect

[68] In the case of a plan that provides lump-sum benefits determined solely as required under the minimum value rules (rather than using an interest rate that results in larger lump-sum benefits), the interest rate specified in the plan is the interest rate or method applicable under the minimum value rules. Thus, for purposes of applying the benefit limits to lump-sum benefits under the plan, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate or method applicable under the minimum value rules.

[69] A special transition rule, described below, applies for 2004 and 2005.

[70] Whether a plan was subject to the deficit reduction contribution rules for the plan year beginning in 2000 is determined without regard to the rule that allows the temporary conservative long-term corporate bond rate to be used for lookback rule purposes, as discussed below.

to such a plan, no additional contributions are required under the deficit reduction contribution rules for these years.

*Deduction limits for plan contributions*

The provision increases the limit on deductions for contributions to a defined benefit pension plan. Under the provision, the maximum amount otherwise deductible is not less than the excess (if any) of (1) 130 percent of the plan's current liability, over (2) the value of plan assets.

*Benefit limitations for financially distressed plans*

Under the provision, certain limitations apply to a defined benefit pension plan that is subject to the deficit reduction contribution rules if the plan is a financially distressed plan for a plan year.[71]

A plan is a financially distressed plan for a plan year if: (1) the plan sponsor during any two of the five immediately preceding plan years has an outstanding debt instrument that is rated speculative grade or lower by one or more nationally recognized statistical rating organizations for corporate bonds; and (2) the funded liability percentage of the plan as of the beginning of the preceding plan year is less than 50 percent.[72] Once a plan is a financially distressed plan, the plan continues to be treated as a financially distressed plan for subsequent plan years that begin before the first plan year beginning after: (1) a five-consecutive-year period during which the plan sponsor has no outstanding debt instrument that is rated speculative grade or lower; or (2) a five-consecutive-year period during which the funded liability percentage of the plan as of the beginning of the preceding plan year is at least 50 percent. The Secretary of the Treasury is directed to prescribe rules for applying the definition of a financially distressed plan in cases in which a plan sponsor's outstanding debt instruments are not rated.

Under the provision, if the plan is a financially distressed plan for a plan year, the following limitations apply:

(1) *Restrictions on benefit increases.*—No plan amendment may take effect during the plan year if the amendment increases plan liabilities by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan. If a plan amendment is adopted in violation of this limitation, the provisions of the plan are to be applied without regard to the amendment.

(2) *Freezing and elimination of benefits.*—Each participant's accrued benefit, any death or disability benefits, and any social security supplement[73] under the plan must be frozen as of the end of the preceding year. Such benefits are determined without regard to any plan amendment adopted during the preceding plan year that increased benefits and are determined after the application of this limitation if it applied for the preceding year. In addition, all other benefits provided under the plan must be eliminated. Freezing or

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[71] The provision does not apply to plans that are not subject to the deficit reduction contribution rules, i.e., multiemployer plans and single-employer plans with no more than 100 participants on any day in the preceding plan year.

[72] For this purpose, funded liability percentage is determined taking into account only vested benefits and using the interest rate applicable in determining PBGC variable rate premiums and the fair market value of the plan assets.

[73] For this purpose, social security supplement has the meaning as described in Code section 411(a)(9).

elimination of benefits is required only to the extent that the implementation of the benefit freeze or elimination by a plan amendment adopted at the end of the preceding plan year would have been permitted under the anticutback rules.

(3) *Restrictions on distributions.*—In the case of a participant or beneficiary whose annuity starting date occurs in the plan year, the plan may not make: (a) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan); (b) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); or (c) any other payment specified by the Secretary of the Treasury by regulations.[74] This restriction continues to for the period during which the plan is a financially distressed plan.

If a plan is a financially distressed plan for a plan year, but the plan's funded current liability percentage as of the beginning of the preceding plan year is at least 50 percent, the requirement that benefits be frozen or eliminated as described in (2) above no longer applies. Thus, benefits under the plan are determined without regard to any freezing or elimination of benefits that was required as a result of financially distressed plan status. In addition, a plan amendment that increases plan liabilities by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan may take effect, but only if the funded current liability percentage as of the end of the plan year is projected to be at least 50 percent (taking into account the effect of the amendment).

These limitations generally apply for the first plan year for which a plan is a financially distressed plan. However, in the case of a plan maintained pursuant to a collective bargaining agreement that is in effect before the beginning of the first plan year for which a plan is a financially distressed plan, the limitations do not apply to plan benefits pursuant to, and individuals covered by, the agreement for plan years beginning before the date on which the agreement terminates (determined without regard to any extension of the agreement).

If a plan is a financially distressed plan for a plan year, the employer must, at least 45 days before the beginning of the plan year, provide notice to each plan participant and beneficiary, each labor organization representing such participants or beneficiaries, and the PBGC. The notice must explain: (1) that the plan is treated as a financially distressed plan and the reasons why it is so treated; and (2) the restrictions applicable to the plan for the plan year as a result of financially distressed status. The notice must be provided in a form and manner as prescribed by the Secretary of the Treasury. The Secretary may provide for the coordination of this notice requirement with the notice required if a plan is amended to provide for a significant reduction in the rate of future benefit accrual. The notice must be written in a manner so as to be understood by the average plan participant and may be provided in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the person to whom notice is re-

[74] Permissible distributions are determined by reference to Code section 401(a)(32)(B) and ERISA section 206(e)(2) (relating to payments if a plan has a liquidity shortfall).

quired to be provided. An employer that fails to provide the required notice to a participant, beneficiary, or the PBGC may (in the discretion of a court) be liable to the participant, beneficiary, or PBGC in the amount of up to $100 a day from the date of the failure, and the court may in its discretion order such other relief as it deems proper.

*Treasury recommendations*

The Secretary of the Treasury is required by December 31, 2004, to submit recommendations for future changes to the funding rules to strengthen the funded status of plans, including recommendations relating to the disclosure of funded status. Such recommendations are to be submitted 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.

EFFECTIVE DATE

*Interest rate used to determine current liability and PBGC premiums*

The provision is generally effective for plan years beginning after December 31, 2003. For purposes of applying certain rules ("lookback rules") to plan years beginning after December 31, 2003, the amendments made by the provision may be applied as if they had been in effect for all years beginning before the effective date. For purposes of the provision, "lookback rules" means: (1) the rule under which a plan is not subject to the additional funding requirements for a plan year if 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; and (2) the rule under which quarterly contributions are required for a plan year if the plan's funded current liability percentage was less than 100 percent for the preceding plan year. The Secretary of the Treasury may prescribe simplified assumptions that may be used in applying the provision for prior plan years for purposes of the lookback rules. The amendments made by the provision may be applied for purposes of the lookback rules, regardless of the funded current liability percentage reported for the plan on the plan's annual reports (i.e., Form 5500) for preceding years.

*Interest rate used to determine minimum lump-sum benefits*

The provision is effective for plan years beginning after December 31, 2006.

The provision provides a special rule that allows a plan amendment to change the interest rate used to determine certain optional forms of benefit. Under the special rule, a plan amendment will not violate the anticutback rule if: (1) for the last plan year beginning in 2003, the plan provides that the annual rate of interest on 30-year Treasury securities is used in determining the amount of a benefit (other than the accrued benefit) that is not subject to the minimum value rules; (2) the plan is amended to provide that a different rate of interest is used in determining the amount of such benefit; and (3) the first plan year for which such amendment is effective begins no later than January 1, 2007. The provision of the bill relating to plan amendments (sec. 471 of the bill) applies to a plan amendment made pursuant to the special rule.

*Interest rate used to apply benefit limits to lump sums*

The provision is generally effective for years beginning after December 31, 2003. In the case of years beginning in 2004 or 2005, the provision does not apply if a greater benefit is permitted by applying the benefit limits without regard to the provision.

*Deficit reduction contribution relief*

The provision is effective on the date of enactment.

*Deduction limits for plan contributions*

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

*Benefit limitations for certain financially distressed plans*

The provision relating to benefit limitations for financially distressed plans is generally effective for plan years beginning after December 31, 2006. The Secretary of the Treasury is directed to issue rules implementing this provision by December 31, 2005.

In the case of a plan maintained pursuant to one or more collective bargaining agreements ratified by the date of enactment, the provision does not apply to employees covered by such an agreement for plan years beginning before the later of (1) the date on which the last of such agreements terminates (determined without regard to any extension thereof on or after the date of enactment), or (2) January 1, 2007.

*Treasury recommendations*

The provision directing the Secretary of the Treasury to submit recommendations relating to the funding rules is effective on the date of enactment.

## 2. Updating deduction rules for combination of plans (sec. 409 of the bill and secs. 404(e)(7) and 4972 of the Code)

### PRESENT LAW

Employer contributions to qualified retirement plans are deductible subject to certain limits.[75] In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over ten years, but limited to the full funding limitation for the year. However, the maximum amount of deductible contributions is generally not less than the plan's unfunded current liability.[76]

[75] Sec. 404

[76] 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.

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.[77] 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.[78] 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.[79] Certain contributions to a defined contribution plan that are 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.

### REASONS FOR CHANGE

The Committee understands that many employers are required to make substantial contributions to their defined benefit pension plans and that in such cases the overall limit on employer deductions for contributions to combinations of defined benefit and defined contribution plans can operate to reduce the deduction attributable to contributions to defined contribution plans. The Committee believes that stability in the ability to make deductible defined contribution plan contributions up to certain levels is desirable.

### EXPLANATION OF PROVISION

Under the provision, 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 provision, for purposes of determining the excise tax on nondeductible contributions, matching contributions

[77] Sec. 404(a)(7).
[78] Sec. 404(n). The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.
[79] Sec. 4972.

to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded.

EFFECTIVE DATE

The provision is effective for contributions for taxable years beginning after December 31, 2004.

## B. Improvements in Portability and Distribution Provisions

### 1. Purchase of permissive service credit (sec. 411 of the bill and secs. 403(b)(13), 415(n)(3), and 457(e)(17) of the Code)

PRESENT LAW

*In general*

Present law imposes limits on contributions and benefits under qualified plans.[80] 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 ($165,000 for 2004) 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.[81]

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.[82]

[80] Sec. 415.
[81] Sec. 415(n)(3).
[82] Priv. Ltr. Rul. 200229051 (April 26, 2002).

*Nonqualified service*

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

*Trustee-to-trustee transfers to purchase permissive service credit*

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).[83]

REASONS FOR CHANGE

The Committee believes that allowing employees to use their section 403(b) annuity and governmental section 457 plan benefits to purchase permissive service credits or make repayments with respect to forfeitures of service credit results in more significant retirement benefits for employees who would not otherwise be able to afford such credits or repayments. The Committee believes that it is appropriate to modify the provisions regarding such transfers in order to facilitate such purchases or repayments. The Committee also believes that it is appropriate to expand the definition of permissive service credit and to allow participants to purchase credit for other periods deemed appropriate by the public retirement systems.

EXPLANATION OF PROVISION

*Permissive service credit*

The provision modifies the definition of permissive service credit by providing 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 increased 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 otherwise offered under the same plan) as long as it

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

relates to benefits to which the participant is not otherwise entitled.

The provision allows participants to purchase credit for periods regardless of whether service is performed, subject to the limits on nonqualified service.

Under the provision, service as an employee of an educational organization providing elementary or secondary education can be determined under the law of the jurisdiction in which the service was performed. Thus, for example, permissive service credit can be granted for time spent teaching outside of the United States without being considered nonqualified service credit.

*Trustee-to-trustee transfers to purchase permissive service credit*

The provision provides that the limits regarding nonqualified service are not applicable in determining whether a trustee-to-trustee transfer from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan is for the purchase of permissive service credit. Thus, failure of the transferee plan to satisfy the limits does not cause the transferred amounts to be included in the participant's income. As under present law, the transferee plan must satisfy the limits in providing permissive service credit as a result of the transfer.

The provision provides that trustee-to-trustee transfers under sections 457(e)(17) and 403(b)(13) may be made regardless of whether the transfer is made between plans maintained by the same employer. The provision 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 are subject to the distribution rules applicable under the Internal Revenue Code to the defined benefit plan.

EFFECTIVE DATE

The provision is generally effective as if included in the amendments made by section 1526(a) of the Taxpayer Relief Act of 1997, except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

2. Rollover of after-tax amounts (sec. 412 of the bill and sec. 402(c)(2) of the Code)

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.[84]

REASONS FOR CHANGE

Under present law, tax-sheltered annuities may provide for after-tax contributions, but are not permitted to receive rollovers of after-tax contributions from qualified retirement plans. Under present law, after-tax contributions cannot be rolled over into a defined benefit plan. The Committee wishes to expand opportunities for portability with respect to after-tax contributions.

EXPLANATION OF PROVISION

The provision 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) or to a tax-sheltered annuity. 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, 2004.

3. Application of minimum distribution rules to governmental plans (sec. 413 of the bill)

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 partic-

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

ipant attains age 70½ 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 70½. 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.

### REASONS FOR CHANGE

The Committee believes that governmental plans should be provided greater flexibility in complying with the minimum distribution requirements to accommodate plan designs commonly used by governmental plans.

### EXPLANATION OF PROVISION

The provision 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.

## 4. Waiver of 10-percent early withdrawal tax on certain distributions from pension plans for public safety employees (sec. 414 of the bill and sec. 72(t) of the Code)

### PRESENT LAW

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, 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.

REASONS FOR CHANGE

The Committee recognizes that public safety employees often retire earlier than workers in other professions. The Committee believes that public safety employees who separate from service after age 50 should be permitted to receive distributions from defined benefit pension plans without the imposition of the early withdrawal tax.

EXPLANATION OF PROVISION

Under the provision, the 10-percent early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is an employee of 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.

5. Rollovers by nonspouse beneficiaries of certain retirement plan distributions (sec. 415 of the bill and and secs. 402, 403(a)(4), 403(b)(8), and 457(e)(16) of the Code)

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.[85]

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.[86] 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.[87] 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.

[85] 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).

[86] 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.

[87] 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.

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

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

*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 70½ or (2) retires.[88] 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 70½. 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.

REASONS FOR CHANGE

The Committee understands that, in practice, many plans provide that distributions to a beneficiary who is not the surviving spouse of the participant are paid out soon after the death of participant in a lump sum, even though the minimum distribution rules would permit a longer payout period. The Committee understands that many beneficiaries would like to avoid the adverse tax consequences of an immediate lump sum, as well as take advantage of the opportunity to receive periodic payments for life or over the beneficiary's lifetime. The Committee wishes to provide beneficiaries with additional flexibility regarding timing of distributions, consistent with the minimum distribution rules applicable to nonspouse beneficiaries. To accomplish this result, the Committee bill allows nonspouse beneficiaries to roll over benefits received after the death of the participant to an IRA and to receive distribu-

[88] In the case of five-percent owners and distributions from an IRA, distributions must begin by April 1 of the calendar year following the year in which the individual attains age 70½.

tions in a manner consistent with the minimum distribution rules for nonspouse beneficiaries.

EXPLANATION OF PROVISION

The provision 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 provision applies to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

EFFECTIVE DATE

The provision is effective for distributions made after December 31, 2004.

6. Faster vesting of employer nonelective contributions (sec. 416 of the bill, sec. 411 of the Code, and sec. 203 of ERISA)

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.[89]

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.

REASONS FOR CHANGE

For many employees, a defined contribution plan is the only type of retirement plan offered by their employer. Providing faster vesting for all employer contributions to such plans will enable shorter-service employees to accumulate greater retirement savings.

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

In addition, providing the same vesting rule for all employer contributions to defined contribution plans will provide simplification.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for contributions (including allocations of forfeitures) for plan years beginning after December 31, 2004, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

7. Allow direct rollovers from retirement plans to Roth IRAs (sec. 417 of the bill and sec. 408A(e) of the Code)

PRESENT LAW

*IRAs in general*

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

*Traditional IRAs*

An individual may make deductible contributions to an IRA up to the lesser of a dollar limit (generally $3,000 for 2004)[90] or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan.[91] 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 59½ 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.

[90] 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.

[91] 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.

*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 of an individual's 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 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to $10,000.

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

*Rollover contributions*

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

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

REASONS FOR CHANGE

Under present law if an individual wishes to roll over amounts from a qualified retirement plan or similar arrangement to a Roth IRA, they may do so, but only by first making a rollover into a traditional IRA and then converting the amounts in the traditional IRA into a Roth IRA. The Committee believes it unnecessary to impose such complications on rollovers from qualified retirement plans to Roth IRAs.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for distributions made after December 31, 2004.

8. Elimination of higher early withdrawal tax on certain SIMPLE plan distributions (sec. 418 of the bill and sec. 72(t) of the Code)

PRESENT LAW

*SIMPLE plans*

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: (1) that employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year; and (2) that do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA")[92] for each employee or part of a qualified cash or deferred arrangement (a "section 401(k) plan").[93] The rules applicable to SIMPLE IRAs and SIMPLE section 401(k) plans are similar, but not identical.

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 section 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to section 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules apply to SIMPLE section 401(k) plans.

Elective deferrals under a section 401(k) plan generally may not be distributable before the occurrence of certain specified events, such as severance of employment, death, disability, attainment of age 59½, or financial hardship. This restriction on distributions applies to elective deferrals made under a SIMPLE section 401(k) plan, but not elective deferrals made under a SIMPLE IRA.

*Early withdrawal tax*

Taxable distributions made from an IRA or from certain employer-sponsored retirement plans (including a section 401(k) plan) before age 59½, death, or disability generally are subject to an additional 10-percent income tax. Early withdrawals from a SIMPLE plan generally are subject to the additional 10-percent tax. However, in the case of a SIMPLE IRA, early withdrawals during the

[92] A SIMPLE IRA may not be in the form of a Roth IRA. References herein to IRAs do not refer to Roth IRAs.

[93] Because State or local governments generally are not permitted to maintain section 401(k) plans, they also generally are not permitted to maintain SIMPLE section 401(k) plans. However, a State or local governments with a pre-May 6, 1986, grandfathered section 401(k) plan may adopt a SIMPLE section 401(k) plan.

two-year period beginning on the date the employee first participated in the SIMPLE IRA are subject to an additional 25-percent tax.

REASONS FOR CHANGE

The Committee believes that early withdrawals from SIMPLE IRAs should be subject to the same additional tax as other early withdrawals.

EXPLANATION OF PROVISION

The provision eliminates the 25-percent tax on early withdrawals from a SIMPLE IRA 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.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2004.

### 9. SIMPLE plan portability (sec. 419 of the bill and secs. 402(c) and 408(d) of the Code)

PRESENT LAW

Under present law, certain small businesses can establish a simplified retirement plan called the savings incentive match plan for employees ("SIMPLE") retirement plan. SIMPLE plans can be adopted by employers: (1) that employ 100 or fewer employees who received at least $5,000 in compensation during the preceding year; and (2) that do not maintain another employer-sponsored retirement plan. A SIMPLE plan can be either an individual retirement arrangement (an "IRA")[94] for each employee or part of a qualified cash or deferred arrangement (a "section 401(k) plan").[95] The rules applicable to SIMPLE IRAs and SIMPLE section 401(k) plans are similar, but not identical.

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 section 401(k) plan, the SIMPLE does not have to satisfy the special nondiscrimination tests applicable to section 401(k) plans and is not subject to the top-heavy rules. The other qualified retirement plan rules apply to SIMPLE section 401(k) plans.

Distributions from employer-sponsored retirement plans and IRAs (including SIMPLE plans) are generally includible in gross income, except to the extent the amount distributed represents a return of after-tax contributions (i.e., basis). If certain requirements are satisfied, distributions from a tax-favored retirement arrangement (i.e., a qualified retirement plan, a tax-sheltered annuity, a

[94] A SIMPLE IRA may not be in the form of a Roth IRA. References herein to IRAs do not refer to Roth IRAs.

[95] Because State or local governments generally are not permitted to maintain seciton 401(k) plans, they also generally are not permitted to maintain SIMPLE section 401(k) plans. However, a State or local government with a pre-May 6, 1986, grandfathered section 401(k) plan may adopt a SIMPLE section 401(k) plan.

governmental section 457 plan, or an IRA) may generally be rolled over on a nontaxable basis to another tax-favored retirement arrangement. However, a distribution from a SIMPLE IRA during the two-year period beginning on the date the employee first participated in the SIMPLE IRA may be rolled over only to another SIMPLE IRA.

REASONS FOR CHANGE

The Committee believes that allowing rollovers between SIMPLE IRAs and other tax-favored retirement arrangements will help preserve retirement savings.

EXPLANATION OF PROVISION

The provision allows distributions from a SIMPLE IRA to be rolled over to another tax-favored retirement arrangement (i.e., an IRA, a qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan) and distributions from another tax-favored retirement arrangement to be rollover over to a SIMPLE IRA.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2004.

10. Eligibility for participation in eligible deferred compensation plans (sec. 420 of the bill)

PRESENT LAW

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

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

REASONS FOR CHANGE

The Committee believes that individuals should not be precluded from participating in an eligible deferred compensation plan by reason of certain prior distributions.

EXPLANATION OF PROVISION

Under the provision, 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 provision is effective on the date of enactment.

11. Benefit transfers to the PBGC (sec. 421 of the bill, sec. 401(a)(31) of the Code, and sec. 4050 of ERISA)

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.[96] 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.[97] That is, the plan administrator must make a direct trustee-to-trustee transfer of the distribution to an IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

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

*Missing participant benefits*

In the case of a defined benefit pension plan that is subject to the plan termination insurance program under Title IV of the Employee Retirement Income Security Act of 1974 ("ERISA"), is maintained by a single employer, and terminates under a standard ter-

[96] 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.

[97] 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 harbos for satisfying fiduciary requirements related to automatic rollovers. Proposed regulations providing such a safe harbor were issued by the Department of Labor, to be effective six months after the issuance of final regulations. 69 Fed. Reg. 9900 (March 2, 2004). The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

mination, 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.[98]

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.

### Reasons for Change

The Committee believes that allowing plan administrators to make automatic rollovers to the PBGC will facilitate automatic rollovers and reduce administrative burdens while providing adequate participant protections.

### Explanation of Provision

The provision provides an alternative to the automatic rollover to an IRA of an involuntary distribution that exceeds $1,000. Under the provision, 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.[99] The written explanation provided to the participant by the plan administrator before the involuntary distribution must explain that a transfer to the PBGC will be made unless the participant elects otherwise.

The provision 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 provision 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 provision is generally effective as if included in the amendments made by section 657 of EGTRRA, i.e., after the issuance of final regulations by the Department of Labor. The extension of the PBGC missing participant program to involuntary distributions that are transferred to the PBGC is effective for distributions made

[98] Secs. 4041(b)(3)(A) and 4050 of ERISA.
[99] The provision applies to all automatic rollovers, not just those for missing participants.

after the issuance of final regulations implementing such extension. The PBGC is directed to issue such regulations not later than December 31, 2004.

## C. Administrative Provisions

### 1. Improvement of Employee Plans Compliance Resolution System (sec. 431 of the bill)

#### 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.[100] 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.

[100] Rev. Proc. 2003–44, 2003–25 I.R.B. 1051.

### REASONS FOR CHANGE

The Committee commends the IRS for the establishment of EPCRS and agrees with the IRS that EPCRS should be updated and improved periodically. The Committee believes that future improvements should facilitate use of the compliance and correction programs by small employers and expand the flexibility of the programs.

### EXPLANATION OF PROVISION

The provision 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 provision, 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 provision is effective on the date of enactment.

## 2. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules (sec. 432 of the bill, sec. 1505 of the Taxpayer Relief Act of 1997, and secs. 401(a) and 401(k) of the Code)

### 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.[101]

### REASONS FOR CHANGE

The Committee believes that application of the nondiscrimination and minimum participation rules to governmental plans is unnecessary and inappropriate in light of the unique circumstances

[101] 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.

under which such plans and organizations operate. Further, the Committee believes that it is appropriate to provide for consistent application of the minimum coverage, nondiscrimination, and minimum participation rules for governmental plans.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for plan years beginning after December 31, 2004.

3. Notice and consent period regarding distributions (sec. 433 of the bill, sec. 417(a) of the Code, and sec. 205(c) of ERISA)

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,[102] 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 are applicable, 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.

[102] 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.

REASONS FOR CHANGE

The Committee understands that an employee is not always able to evaluate distribution alternatives, select the most appropriate alternative, and notify the plan of the selection within a 90–day period. The Committee believes that requiring a plan to furnish multiple distribution notices to an employee who does not make a distribution election within 90 days is administratively burdensome. In addition, the Committee believes that participants who are entitled to defer distributions should be informed of the impact of a decision not to defer distribution on the taxation and accumulation of their retirement benefits.

EXPLANATION OF PROVISION

Under the provision, 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 provision and the modifications required to be made under the provision apply to years beginning after December 31, 2004. 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 provision.

4. Pension plan reporting simplification (sec. 434 of the bill)

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.[103] 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.

[103] Treas. Reg. sec. 301.6058–1(a).

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. The plan administrator of a "one-participant plan" generally may file Form 5500–EZ, which consists of only one page. For this purpose, a plan is a one-participant plan 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 plan does not provide benefits to anyone other than the sole owner of the business (or the sole owner and spouse) or the partners in the business (or the partners and spouses); (4) the employer is not a member of a related group of employers; and (5) the employer does not use the services of leased employees. In addition, the plan administrator of a one-participant plan is not required to file a return if the plan does not have an accumulated funding deficiency 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.

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.

### REASONS FOR CHANGE

The Committee believes that simplification of the reporting requirements applicable to plans of small employers will encourage such employers to provide retirement benefits for their employees.

### EXPLANATION OF PROVISION

The Secretary of the Treasury and the Secretary of Labor are directed to modify the annual return filing requirements with respect to a one-participant 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 provision 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 provision relating to one-participant retirement plans is effective for plan years beginning on or after January 1, 2004. The provision relating to simplified reporting for plans with fewer than 25 employees is effective on the date of enactment.

## 5. Missing participants (sec. 435 of the bill and sec. 4050 of ERISA)

### 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.[104]

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.

### REASONS FOR CHANGE

The Committee recognizes that no statutory provision or formal regulatory guidance exists concerning an appropriate method of handling the benefits of missing participants in terminated multiemployer plans or defined contribution plans and other plans not subject to the PBGC termination insurance program. Therefore, sponsors of these plans face uncertainty with respect to the benefits of missing participants. The Committee believes that it is appropriate to extend the established PBGC missing participant program to these plans in order to reduce uncertainty for plan sponsors and increase the likelihood that missing participants will receive their retirement benefits.

### EXPLANATION OF PROVISION

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 pension plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit pension plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

### EFFECTIVE DATE

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

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

6. Reduced PBGC premiums for small and new plans (secs. 436 and 437 of the bill and sec. 4006 of ERISA)

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 pension 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.

REASONS FOR CHANGE

The Committee believes that reducing the PBGC premiums for new plans and plans of small employers will help encourage the establishment of defined benefit pension plans, particularly by small employers.

EXPLANATION OF PROVISION

*Reduced flat-rate premiums for new plans of small employers*

Under the provision, 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 pension 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 provision provides that the variable-rate premium is phased in for new defined benefit pension 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 pension plan is defined as described above under the flat-rate premium provision of the provision 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 provision, 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, 2004. The reduction of the variable-rate premium for small plans applies to plan years beginning after December 31, 2004.

7. Authorization for PBGC to pay interest on premium overpayment refunds (sec. 438 of the bill and sec. 4007(b) of ERISA)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee believes that an employer or other person who overpays PBGC premiums should receive interest on a refund of the overpayment.

EXPLANATION OF PROVISION

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

8. Rules for substantial owner benefits in terminated plans (sec. 439 of the bill and secs. 4021, 4022, 4043, and 4044 of ERISA)

### 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.

### REASONS FOR CHANGE

The Committee believes that the present-law rules concerning limitations on guaranteed benefits for substantial owners are overly complicated and restrictive and thus may discourage some small business owners from establishing defined benefit pension plans.

### EXPLANATION OF PROVISION

The provision 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 provision 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, 2004.

9. Voluntary early retirement incentive and employment retention plans maintained by local educational agencies and other entities (sec. 440 of the bill, secs. 457(e)(11) and 457(f) of the Code, sec. 3(2)(B) of ERISA, and sec. 4(*l*)(1) of the ADEA)

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 ($13,000 for 2004). 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 pension plans may lawfully provide payments that constitute the subsidized portion of an early retirement benefit or social security supplements pursuant to ADEA [105], and employers may lawfully provide a voluntary early retirement incentive plan that is consistent with the purposes of ADEA.[106]

REASONS FOR CHANGE

The Committee is aware that some public school districts and related tax-exempt education associations provide certain employees with voluntary early retirement incentive benefits similar to benefits that can be provided under a defined benefit pension plan. If provided under a defined benefit pension plan, these benefits would

[105] See ADEA sec. 4(I)(1).
[106] See ADEA sec. 4(f)(2).

not be includible in income until paid and would also generally be permitted under ADEA. However, for reasons related to the structure of State-maintained defined benefit pension plans covering these employees and fiscal operations of the local school districts, these benefits are provided to the employees directly, rather than under the defined benefit pension plan. The Committee believes it is appropriate to treat these benefits in a manner similar to the treatment that would apply if the benefits were provided under the defined benefit pension plan. The Committee also believes that it is appropriate to address the treatment of certain employment retention plans maintained by local school districts and related tax-exempt education associations.

EXPLANATION OF PROVISION

*Early retirement incentive plans of local educational agencies and education associations*

The provision addresses the treatment of certain voluntary early retirement incentive plans under section 457, ERISA, and ADEA.

*Code section 457*

Under the provision, special rules apply under section 457 to a voluntary early retirement incentive plan 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 pension plan maintained by a State or local government or by such an association. Such a voluntary early retirement incentive plan 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 pension plan. For purposes of the provision, the payments or supplements that could otherwise be provided under the defined benefit pension plan are to be determined by applying the accrual and vesting rules for defined benefit pension plans.[107]

*ERISA*

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

*ADEA*

The provision also addresses the treatment under ADEA of voluntary early retirement incentive plans 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 pension plan maintained by a State or local government or

[107] 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 pension plan; however, government plans are exempt from these rules.

by such an association. Under the provision, for purposes of ADEA, such a plan is treated as part of the defined benefit pension 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 provision addresses the treatment of certain employment retention plans under section 457 and ERISA. The provision 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 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 provision, 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 ($13,000 for 2004). The provision 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 provision, 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 provision 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 provision alters or affects the construction of the Code, ERISA, or ADEA as applied to any plan, arrangement, or conduct to which the provision does not apply.

10. Two-year extension of transition rule to pension funding requirements (sec. 769(c) of the Retirement Protection Act of 1994)

PRESENT LAW [108]

Under present law, defined benefit plans are required to meet certain minimum funding rules. In some cases, additional contributions are required if a defined benefit 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

[108] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Pension Equity Funding Act of 2004, Pub. L. No. 108–218 (April 10, 2004).

liability means all liabilities to employees and their beneficiaries under the plan. 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 PBGC insures benefits under most single-employer defined benefit 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 the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

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.

### REASONS FOR CHANGE

The present-law funding rules for plans maintained by certain interstate bus companies were enacted because the generally applicable funding rules required greater contributions for such plans than were warranted given the special characteristics of such plans. In particular, these plans are closed to new participants and have demonstrated mortality significantly greater than that predicted under mortality tables that the plans would otherwise be required to use for minimum funding purposes. The Committee believes that it is appropriate to provide an extension of the special minimum funding rules for these plans for two years.

### EXPLANATION OF PROVISION

[The bill does not include the provision relating to the special funding rules for plans sponsored by a company engaged primarily in interurban or interstate passenger bus service as approved by the Committee because an identical provision was enacted into law in the Pension Funding Equity Act of 2004 (Pub. L. No. 108–218) subsequent to Committee action on the bill. The following discussion describes the Committee action.]

The provision approved by the Committee would have modified 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 would be treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for these years, additional contributions and quarterly contributions would not be required with respect to the plan. In addition, for these years, the mortality table used under the plan would be used in determining the amount of unfunded vested benefits under the plan for purposes of calculating PBGC variable rate premiums.

EFFECTIVE DATE

The provision approved by the Committee would have been effective with respect to plan years beginning after December 31, 2003.

11. Acceleration of PBGC computation of benefits attributable to recoveries from employers (sec. 441 of the bill and secs. 4022(c) and 4062(c) of ERISA)

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.[109] 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 2004, the maximum guaranteed benefit for an individual retiring at age 65 is $3,698.86 per month, or $44,386.32 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

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

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.

*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.

### REASONS FOR CHANGE

The Committee wishes to modify the rules for calculating certain recoveries by the PBGC to accelerate the time by which such recoveries can be determined, thereby accelerating the time by which benefits may be paid to participants in terminated plans.

### EXPLANATION OF PROVISION

The provision 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 so that the period begins two years earlier. For example, the average recovery ratio for a plan terminating in 2004 is based on recovery experience for plan terminations in 1997–2001, rather than 1999–2003.

In addition, the provision 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.

The provision 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 provision 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.

12. Multiemployer plan funding and solvency notices (sec. 442 of the bill and sec. 101 of ERISA)

PRESENT LAW [110]

Under present law, defined benefit plans are generally required to meet certain minimum funding rules. These rules are designed to help ensure that such plans are adequately funded. Both single-employer plans and multiemployer plans are subject to minimum funding requirements; however, the requirements are different for each type of plan.

Similarly, the Pension Benefit Guaranty Corporation ("PBGC") insures certain benefits under both single-employer and multiemployer defined benefit plans, but the rules relating to the guarantee vary for each type of plan. In the case of multiemployer plans, the PBGC guarantees against plan insolvency. Under its multiemployer program, PBGC provides financial assistance through loans to plans that are insolvent (that is, plans that are unable to pay basic PBGC-guaranteed benefits when due).

Employers maintaining single-employer defined benefit plans are required to provide certain notices to plan participants relating to the funding status of the plan. For example, ERISA requires an employer which sponsors a single-employer defined benefit plan to notify plan participants if the employer fails to make required contributions (unless a request for a funding waiver is pending).[111] In addition, in the case of an underfunded plan for which variable rate PBGC premiums are required, the plan administrator generally must notify plan participants of the plan's funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.[112]

Employers maintaining multiemployer defined benefit plans which are in reorganization status are required to provide plan participants with certain information if the plan becomes insolvent. If such a plan becomes insolvent, employers must notify plan participants that certain benefit payments will be suspended but that basic benefits will continue to be paid.[113]

REASONS FOR CHANGE

The Committee believes that participants in multiemployer plans should be furnished with information about the plan's funded status and the limitations on the guarantee of benefits by the PBGC, including the circumstances in which the guarantee would come into effect. The Committee also believes that such participants should be provided with information about the value of the plan's assets and the amount of benefit payments as well as the rules

[110] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Pension Funding Equity Act of 2004 ("PFEA 2004"), Pub. L. No. 108–218 (April 10, 2004). Section 103 of PFEA 2004 requires all multiemployer plans to provide an annual notice that contains certain information relating to the plan and its funding status and certain information relating to PBGC coverage of multiemployer plan benefits. A civil penalty is assessable for failures to provide the required notice. Section 103 of PFEA 2004 is effective for plan years beginning after December 31, 2004.

[111] ERISA sec. 101(d).

[112] ERISA sec. 4011. Multiemployer plans are not required to pay variable rate premiums.

[113] Code sec. 418E; ERISA sec. 4245.

governing insolvent multiemployer plans. Requiring administrators of multiemployer plans to provide participants with annual notices regarding plan funding and solvency will help keep participants in multiemployer plans adequately informed about their retirement benefits.

EXPLANATION OF PROVISION

*In general*

Under the provision, the administrator of a multiemployer plan which is a defined benefit pension plan is required to provide: (1) an annual funding notice; and (2) if the value of the plan's assets as of the end of the plan year is less than five times the amount of benefits paid by the plan for the year, a solvency notice, to (1) each participant and beneficiary; (2) each labor organization representing such participants and beneficiaries; and (3) each employer that has an obligation to contribute under the plan.

Both notices are required to 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, each plan sponsor's employer identification number, and the plan identification number; (2) 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 (3) any additional information which the plan administrator elects to include.

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

*Additional information to be included*

*Funding notice*

In addition to the information described above, the required annual funding notice must also include a statement as to whether the plan's funded current liability percentage for the plan year to which the notice relates is at least 100 percent (and if not, a statement of the percentage).

*Solvency notice*

In addition to the information described above, a solvency notice must include (1) 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 plan year to which the notice relates and (2) a summary of the rules governing insolvent multiemployer plans, including the applicable limitation on benefit payments and potential benefit reductions and suspensions, and their potential effect on the plan.

*Sanction for failure to provide notice*

In the case of a failure to provide either of the required notices, 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 notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

EFFECTIVE DATE

The provision applies to plan years beginning after December 31, 2005.

13. No reduction in unemployment compensation as a result of pension rollovers (sec. 443 of the bill and sec. 3304(a)(15) of the Code)

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.

REASONS FOR CHANGE

Unlike an individual's unemployment compensation, rollover distributions are not intended to meet current living expenses. To the extent that a reduction of an individual's unemployment compensation results in that individual liquidating a portion of a rollover distribution to meet current living expenses, the Committee believes that the purpose of the rules permitting rollover distributions, which are designed to ensure that the amounts contributed to employer-sponsored retirement plans or IRAs are used for retirement purposes, are defeated.

EXPLANATION OF PROVISION

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.

### 14. Withholding on certain distributions from governmental eligible deferred compensation plans (sec. 444 of the bill and sec. 457 of the Code)

PRESENT LAW

Before the Economic Growth and Tax Relief Reconciliation Act of 2001[114] ("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.[115] 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.

REASONS FOR CHANGE

The Committee believes that distributions that have already begun from governmental section 457 plans under the prior-law rules should not have to be modified to conform to the EGTRRA withholding provisions.

EXPLANATION OF PROVISION

Under the provision, 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 provision is effective as if included in EGTRRA.

### 15. Minimum cost requirement for excess asset transfers (sec. 445 of the bill and sec. 420 of the Code)

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 in-

[114] Pub. L. No. 107–16.
[115] EGTRRA sec. 641.

cludible 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.[116] 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, 2013.[117]

Excess assets generally means the excess, if any, of the value of the plan's assets[118] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[119] 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 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).

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[116] Sec. 420.

[117] Under present law in effect on the dates of Committee action on the bill, no qualified transfer could be made after December 31, 2005.

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

[119] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets 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), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

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,[120] 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.[121] 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.[122]

### REASONS FOR CHANGE

The Committee believes that it is appropriate to provide greater flexibility in complying with the minimum cost requirement. The Committee believes that the requirement should not be violated if the reduction in health cost is not more that the allowable reduction in retiree health coverage.

### EXPLANATION OF PROVISION

The provision 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.

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.

[120] Treas. Reg. sec. 1.420–1(a).
[121] Treas. Reg. sec. 1.420–1(b)(1).
[122] Treas. Reg. sec. 1.420–1(b)(2).

EFFECTIVE DATE

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

16. Social Security coverage under divided retirement system for public employees in Kentucky

PRESENT LAW [123]

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.

REASONS FOR CHANGE

The Committee believes that it is appropriate to allow the State of Kentucky to offer a divided retirement system.

[123] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Social Security Protection Act of 2004, Pub. L. No. 108–203 (March 2, 2004).

### EXPLANATION OF PROVISION

[The bill does not include the provision relating to allowing the State of Kentucky to offer a divided retirement system as approved by the Committee because an identical provision was enacted into law in the Social Security Protection Act of 2004 (Pub. L. No. 108–203) subsequent to Committee action on the bill. The following discussion describes the Committee action.]

The provision approved by the Committee would have permitted 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 provision, 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 provision approved by the Committee would have been effective on January 1, 2003.

## D. STUDIES

(Secs. 451 and 452 of the bill)

### 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.[124]

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 se-

[124] ERISA sec. 404(c).

curities.[125] 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).

### REASONS FOR CHANGE

The Committee has a continuing interest in retirement income security and in the roles that defined contribution plans and defined benefit plans play in providing that security. The Committee believes it is appropriate to conduct studies of certain issues relating to such plans to determine ways in which retirement security may be enchanced.

### EXPLANATION OF PROVISION

*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

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

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.

## E. Other Provisions

### 1. Additional IRA catch-up contributions for certain individuals (sec. 461 of the bill and sec. 408 of the Code)

PRESENT LAW

Under present law, 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 for a taxable year 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 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 an IRA for a taxable year of up to $500 in 2004–2005 and $1,000 in 2006 and thereafter.

REASONS FOR CHANGE

The Committee recognizes that, if employer matching contributions are made in the form of employer stock, the employer's bankruptcy may cause employees to lose a substantial portion of their retirement savings. The Committee believes that employees should be permitted to make up for such losses by making additional IRA contributions.

EXPLANATION OF PROVISION

Under the provision, an eligible individual would be permitted to make additional contributions to an IRA up to $1,500 per year in 2004 and 2005, and $3,000 per year in 2006–2008. To be eligible to make these additional contributions, an individual must have been a participant in a section 401(k) plan 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. An individual eligible to make these additional contributions is not permitted to make IRA catch-up contributions that apply to individuals age 50 and older.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2003, and before January 1, 2009.

2. Distributions by an S corporation to an employee stock ownership plan (sec. 462 of the bill and sec. 4975 of the Code)

PRESENT LAW

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 qualifying employer securities. For purposes of ESOP investments, a "qualifying employer security" is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP. 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.[126] 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 qualifying employer securities.[127] In such a case, the employer securities purchased with the loan proceeds are 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 for allocation 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 qualifying employer securities. No person entitled to payments under the loan can have the right to any assets of the ESOP other than

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

(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).[128] 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.

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, in accordance with plan provisions, a dividend paid with respect to qualifying employer securities held by the ESOP is used to make payments on a loan (including payments of interest as well as principal) that was used to acquire the employer securities (whether or not allocated to participants).[129] In the case of a dividend paid with respect to any employer security that is allocated to a participant, this relief does not apply unless the plan provides that employer securities 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.[130]

Effective for taxable years beginning after December 31, 1997, a qualified retirement plan (including an ESOP) may be a shareholder of an S corporation.[131] As a result, an S corporation may maintain an ESOP.

### REASONS FOR CHANGE

The Committee believes that distributions made with respect to S corporation stock that is held by an ESOP and that was purchased with an exempt loan should be permitted to be used to repay the loan, subject to the same conditions that apply to C corporation dividends used to repay an exempt loan.

### EXPLANATION OF PROVISION

Under the provision, an ESOP maintained by an S corporation is not treated as violating the qualification requirements of the Code or as engaging in a prohibited transaction merely because, in accordance with plan provisions, a distribution made with respect to S corporation stock that constitutes qualifying employer securities held by the ESOP is used to repay a loan that was used to acquire the securities (whether or not allocated to participants). This relief does not apply in the case of a distribution with respect to S corporation stock that is allocated to a participant unless the plan provides that 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 provision is effective January 1, 1998.

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[128] Treas. reg. sec. 54.4975–7(b)(5).
[129] Sec. 404(k)(5)(B).
[130] Sec. 404(k)(2)(B).
[131] Sec. 1361(c)(6).

### 3. Permit qualified transfers of excess pension assets to retiree health accounts by multiemployer plan (sec. 463 of the bill, sec. 420 of the Code and secs. 101, 403 and 408 of ERISA)

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.[132] 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. A qualified transfer may not be made from a multiemployer plan. No qualified transfer may be made after December 31, 2013.[133]

Excess assets generally means the excess, if any, of the value of the plan's assets[134] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[135] 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

[132] Sec. 420.

[133] Under present law in effect on the dates of Committee action on the bill, no qualified transfer could be made after December 31, 2005.

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

[135] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets 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), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

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.[136]

Under present law, special deduction rules apply to a multiemployer defined benefit plan established before January 1, 1954, under an agreement between the Federal government and employee representatives in a certain industry.[137]

### REASONS FOR CHANGE

The Committee believes that it is appropriate to allow the multiemployer defined benefit plan to which special deduction rules apply to make qualified transfers of excess benefit plan assets.

### EXPLANATION OF PROVISION

The provision allows qualified transfers of excess defined benefit plan assets to be made by the multiemployer defined benefit plan to which special deduction rules apply (or a continuation or spinoff thereof) that primarily covers employees in the building and construction industry.

### EFFECTIVE DATE

The provision is effective for transfers made in taxable years beginning after December 31, 2004.

## F. PLAN AMENDMENTS

(Sec. 471 of the bill)

### 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.[138]

[136] ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.
[137] Code sec. 404(c).
[138] Sec. 401(b).

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.[139] This prohibition on the reduction of accrued benefits is commonly referred to as the "anticutback rule."

REASONS FOR CHANGE

The Committee believes that employers should have adequate time to amend their plans to reflect changes in the law while operating their plans in compliance with such changes.

EXPLANATION OF PROVISION

The provision 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[140] ("EGTRRA"), or regulations issued thereunder, to be retroactively effective. If the plan amendment meets the requirements of the provision, then the plan will be treated as being operated in accordance with its terms and the amendment will not violate the 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 provision 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.

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

[139] Code sec. 411(d)(6)l ERISA sec. 204(g).
[140] Pub. L. No. 107–16.

effect before EGTTRA.[141] On the other hand, suppose a plan incorporates the section 401(a)(17) limit on compensation by reference and provides for an employer contribution of three percent of compensation. It is expected that the Secretary will provide that, in that case, the plan cannot be amended retroactively to reduce the contribution percentage for those participants not affected by the section 401(a)(17) limit, even though the reduction will result in the same dollar level of contributions for some participants because of the increase in compensation taken into account under the plan as a result of the increase in the section 401(a)(17) limit under EGTRRA. As another example, suppose that under present law a plan is top-heavy and therefore a minimum benefit is required under the plan, and that under the provisions of EGTRRA, the plan is not considered to be top-heavy. It is expected that the Secretary will generally permit plans to be retroactively amended to reflect the new top-heavy provisions of EGTRRA.

#### EFFECTIVE DATE

The provision is effective on the date of enactment.

## TITLE V. PROVISIONS RELATING TO EXECUTIVES AND STOCK OPTIONS

### A. REPEAL OF LIMITATION ON ISSUANCE OF TREASURY GUIDANCE REGARDING NONQUALIFIED DEFERRED COMPENSATION

(Sec. 501 of the bill)

#### 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

[141] 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.

very broadly for purposes of section 83.[142] 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 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.[143] 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.[144] 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

[142] Treas. Reg. sec. 1.83–3(e). This definition in part reflects previous IRS rulings on nonqualified deferred compensation.
[143] Secs. 404(a)(5), (b) and (d) and sec. 83(h).
[144] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60–31, 1960–1 C.B. 174.

prior or privileged claim.[145] 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.[146] 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.[147]

*Section 132 of the Revenue Act of 1978*

Section 132 of the Revenue Act of 1978[148] 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.[149]

REASONS FOR CHANGE

The Committee is aware of the popular use of deferred compensation arrangements by executives to defer current taxation of substantial amounts of income. Executives often use arrangements that allow deferral of income, but also provide security of future payment to the executive, even if the arrangement, on its face, says otherwise. The Committee is concerned that many nonqualified de-

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

[146] 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.

[147] Prop. Treas. Reg. 1.61–16, 43 Fed. Reg. 4638 (1978).

[148] Pub. L. No. 95–600.

[149] 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.

ferred compensation arrangements have developed which allow improper deferral of income.

The report issued by the staff of the Joint Committee on Taxation on their investigation of Enron Corporation,[150] which was mandated by the Committee, detailed how executives deferred millions of dollars in Federal income taxes through nonqualified deferred compensation arrangements. The staff of the Joint Committee on Taxation found that the restriction imposed by section 132 of the Revenue Act of 1978 may have prevented Treasury from issuing more guidance on nonqualified deferred compensation and may have contributed to aggressive interpretations of present law. Especially given the lack of statutory rules in this area, the lack of administrative guidance allows taxpayers latitude to create and promote arrangements that push the limit of what is allowed under the law. The Joint Committee staff recommended the repeal of section 132.

The Committee believes that the Secretary of the Treasury should issue guidance on nonqualified deferred compensation targeted to arrangements which result in improper deferral of income and should not be bound by the restrictions imposed by Section 132 of the Revenue Act of 1978, which may impede the Treasury Department from issuing appropriate guidance to address such arrangements.

EXPLANATION OF PROVISION

The provision repeals section 132 of the Revenue Act of 1978. The Committee intends 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 bill.

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

[150] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

### EFFECTIVE DATE

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

## B. TAXATION OF NONQUALIFIED DEFERRED COMPENSATION

(Sec. 502 of the bill and new sec. 409A of the Code)

### 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,[151] 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.[152] 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

[151] 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.

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

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 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.[153] 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.[154] 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.[155] 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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[153] Treas. Reg. secs. 1.451–1 and 1.451–2.

[154] 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).

[155] 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.

REASONS FOR CHANGE

The report issued by the staff of the Joint Committee on Taxation on their investigation of Enron Corporation,[156] which was mandated by the Committee, detailed how executives deferred millions of dollars in Federal income taxes through nonqualified deferred compensation arrangements. Over $150 million in compensation was deferred by the 200–highest compensated employees for the years 1998 through 2001.

The Committee is also aware of the popular use of deferred compensation arrangements by executives of many other companies to defer current taxation of substantial amounts of income. The Committee believes that many nonqualified deferred compensation arrangements have developed that allow improper deferral of income. As in the case of Enron, executives often use arrangements that allow deferral of income, but also provide security of future payment to the executive. For example, nonqualified deferred compensation arrangements often contain provisions that allow participants to receive distributions upon request, subject to forfeiture of a minimal amount (i.e., a "haircut" provision).

Since the concept of a rabbi trust was developed, techniques have developed that attempt to protect the assets from creditors despite the terms of the trust. For example, the trust or fund may be located in a foreign jurisdiction, making it difficult or impossible for creditors to reach the assets.

The Committee believes that certain arrangements that allow participants inappropriate levels of control or access to amounts deferred should not result in deferral of income inclusion. The Committee also believes that certain arrangements, such as offshore trusts, which effectively protect assets from creditors, should be treated as funded and not result in deferral of income inclusion.

The finding of the staff of Joint Committee on Taxation support the Committee's views regarding the need for statutory changes in the deferred compensation area.[157] The Joint Committee staff recommended changes to the present-law rules regarding the taxation of nonqualified deferred compensation.

EXPLANATION OF PROVISION

Under the provision, all amounts deferred under a nonqualified deferred compensation plan[158] for all taxable years are currently includible in gross income to the extent not subject to a substantial

[156] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

[157] Id. at Vol. I, 592–637.

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

risk of forfeiture[159] and not previously included in gross income, unless certain requirements are satisfied. If the requirements of the provision 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 provision.

Under the provision, distributions from a nonqualified deferred compensation plan may not be distributed earlier than 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 the acceleration of the time or schedule of any payment under the plan, except as provided in regulations by the Secretary.

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 provision. 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 one year after the date of the change in control. Such individuals include officers (as defined by section 16(a)),[160] directors, or 10–percent owners of publicly-held corporations. Under the provision, distributions made to such individuals within one year of the change in control ("applicable payments") are treated as excess parachute payments under section 280G (even if the payment would not otherwise be treated as an excess parachute payment) and therefore subject to the ex-

[159] 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.

[160] 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.

cise tax under section 4999. As under present law, no deduction is allowed for any amount treated as an excess parachute payment.

If, absent the provision, an applicable payment is a payment in the nature of compensation contingent on a change in control, section 280G shall be applied as if the provision had not been enacted (i.e., the applicable payments shall continue to be taken into account under section 280G). Any resulting excess parachute payment also shall be subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Under the provision, an applicable payment that, absent the provision, is not a payment in the nature of compensation contingent on a change in control is required to be taken into account in determining if the present value of the payments in the nature of compensation contingent on a change in control equal or exceed three times the base amount. Any resulting excess parachute payment also shall be subject to the excise tax under section 4999 (in addition to the tax imposed by the provision). Applicable payments do not include payments made upon death or if the participant becomes disabled. Treasury regulations shall prescribe rules to prevent a deduction from being disallowed more than once.

Unforeseeable emergency is defined as severe financial hardship of the participant or beneficiary resulting from a sudden and unexpected 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 emergency 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 or beneficiary's assets (to the extent such liquidation would not itself cause severe 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 can be expected to last for a continuous period of not less than 12 months; or (ii) is, by reason on any medically determinable physical or mental impairment which can be expected to result in death or can be expected to last for a continuous period of not less than 12 months, receiving income replacement benefits for a period of not less than three months under an accident and health plan covering employees of the individual's employer.

Under the provision, investment options (including phantom or notional 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 defined contribution plan of the employer 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 defined contribution employer plan. The Committee intends 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 defined contribution employer plan, the investment options of the nonqualified deferred compensation plan must meet the requirements prescribed by the Secretary regarding permissible investment options. It is intended that in cases where there is no such qualified defined contribution employer plan, the Secretary issue rules limiting the available investment options.

The provision requires that the plan must provide that compensation for services performed during a taxable year may be deferred at the participant's election only if the election to defer is made no later than during the preceding taxable year, 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 provision, 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 plan requires that the election may not take effect until at least 12 months after the date on which the election is made; (2) except in the case of elections relating to disability, death, or unforeseeable emergency, the plan requires that the first payments with respect to which such election is made be deferred for a period of not less than 5 years from the date such payment would otherwise have been made; and (3) the plan requires that any election related to a payment upon a specified time may not be made less than 12 months prior to the date of the first scheduled payment. 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 (except as provided in regulations by the Secretary). 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 provision, assets set aside (directly or indirectly) in a 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 (whether or not such assets are available to satisfy the claims of general creditors) (1) at the time set aside if such assets are located outside of the United States, or (2) at the time transferred if such assets are subsequently transferred outside of the United States. 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 in which first deferred or, if later, the first taxable year in which such amounts are not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional ten percent tax. The provision 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 provision 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 provision, 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 in which first deferred or, if later, the first taxable year in which such amounts are not subject to a substantial risk of forfeiture. 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.[161] A governmental eligible deferred compensation plan (sec. 457) is also a qualified employer plan under the provision.

Interest imposed under the provision 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 provision. The provision does not prevent the inclusion of amounts in gross income under any provision or rule of law earlier than the time provided in the provision. Any amount required to be included in gross income under the provision shall not be required to be included in gross income under any other rule of law later than the time provided in the provision. The provision does not affect the rules regarding the timing of an employer's deduction for nonqualified deferred compensation.

The provision requires annual reporting to the IRS of amounts deferred. Such amounts are required to be reported on an individ-

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

ual's Form W–2 for the year deferred even if the amount is not currently includible in income for that taxable year. Under the provision, the Secretary is authorized, through regulations, to establish a minimum amount of deferrals below which the reporting requirements do not apply.

The provision provides the Secretary of the Treasury authority to prescribe regulations as are necessary to carry out the purposes of provision, 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 provision.

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 provision is effective for amounts deferred in taxable years beginning after December 31, 2004.

The provision applies to earnings on deferred compensation only to the extent that the provision applies to such compensation.

Not later than 90 days after the date of enactment, the Secretary is directed to issue guidance on what constitutes a change in ownership or effective control.

Not later than 90 days after the date of enactment, the Secretary is directed to issue guidance providing a limited period during which an individual participating in a nonqualified deferred compensation plan adopted before December 31, 2004, may, without violating the provision, terminate participation or cancel an outstanding deferral election with regard to amounts earned after December 31, 2004, if such amounts are includible in income as earned.

### C. DENIAL OF DEFERRAL OF CERTAIN STOCK OPTION AND RESTRICTED STOCK GAINS

(Sec. 503 of the bill and sec. 63 of the Code)

#### 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.

### REASONS FOR CHANGE

The Committee is aware of the use of certain programs that allow executives to defer taxes attributable to stock option gains and restricted stock gains by exchanging their interest in the property for a future payment of such gain. The report issued by the staff of the Joint Committee on Taxation on their investigation of Enron Corporation,[162] which was mandated by the Committee, showed that executives at Enron Corporation deferred Federal income taxes under such programs. The Committee does not believe that such practices should be allowed to continue as they result in inappropriate deferred income.

### EXPLANATION OF PROVISION

Under the provision, gains attributable to stock options (including exercises of stock options), vesting of restricted stock, and other compensation based on employer securities (including employer securities) cannot be deferred by exchanging such amounts for a right to receive a future payment. Except as provided by the Secretary, if a taxpayer exchanges (1) an option to purchase employer securities, (2) employer securities, or (3) any other property based on employer securities for a right to receive future payments, an amount equal to the present value of such right (or such other amount as the Secretary specifies) is required to be included in gross income for the taxable year of the exchange. The provision applies even if

[162] Joint Committee on Taxation, Report of Investigation of Enron Corporation and Related Entities Regarding Federal Tax and Compensation Issues, and Policy Recommendations (JCS–3–03), February 2003.

the future right to payment is treated as an unfunded and unsecured promise to pay. The provision applies when there is in substance an exchange, even if the transaction is not formally structured as an exchange.

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

#### EFFECTIVE DATE

The provision applies to exchanges after December 31, 2004.

### D. INCREASE IN WITHHOLDING FROM SUPPLEMENTAL WAGE PAYMENTS IN EXCESS OF $1 MILLION

(Sec. 504 of the bill and sec. 13273 of the Revenue Reconciliation Act of 1993)

#### 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,[163] based on the third lowest income tax rate under the Code (25 percent for 2004).[164]

#### REASONS FOR CHANGE

The Committee believes that because most employees who receive annual supplemental wage payments in excess of $1 million will ultimately be taxed at the highest marginal rate, it is appropriate to raise the withholding rate on such payments so that withholding more closely approximates the ultimate tax liability with respect to these payments.

#### EXPLANATION OF PROVISION

Under the provision, 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 2004), 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 provision is effective with respect to payments made after December 31, 2003.

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[163] Sec. 13273 of the Revenue Reconciliation Act of 1993.
[164] 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

(Sec. 511 of the bill and secs. 421(b), 423(c), 3121(a), 3231, and 3306(b) of the Code)

### 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.[165]

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.[166] The applicable Code provisions[167] 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[168] 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.

### REASONS FOR CHANGE

The Committee believes that it is appropriate to clarify statutorily the treatment of statutory stock options for employment tax and income tax withholding purposes. The Committee believes that it is appropriate to provide specific exclusions from withholding requirements for wages attributable to statutory stock options.

### EXPLANATION OF PROVISION

The provision 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 provision, FICA and FUTA taxes do not apply upon the

[165] Sec. 421.
[166] Secs. 3101, 3111 and 3301.
[167] Secs. 3121 and 3306.
[168] Notice 2002–47, 2002–28 I.R.B. 97.

exercise of a statutory stock option.[169] The provision also provides that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the provision 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 provision 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

(Sec. 512 of the bill and sec. 421 of the Code)

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.[170]

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.[171]

[169] The provision also provides a similar exclusion for wages under the Railroad Retirement Tax Act.
[170] Sec. 421.
[171] Sec. 1043.

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.

#### REASONS FOR CHANGE

To comply with Federal conflict of interest requirements, executive branch personnel may be required, before the statutory holding period requirements have been satisfied, to divest holdings of stock acquired pursuant to the exercise of statutory stock options. Because Federal conflict of interest requirements mandate the sale of such shares, the Committee believes that such individuals should be afforded the tax treatment that would be allowed had the individual held the stock for the required holding period.

#### EXPLANATION OF PROVISION

Under the provision, 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 provision is effective for sales after the date of enactment.

## TITLE VI. WOMEN'S PENSION PROTECTION

### A. STUDY OF SPOUSAL CONSENT FOR DISTRIBUTIONS FROM DEFINED CONTRIBUTION PLANS

(Sec. 601 of the bill)

#### PRESENT LAW

Qualified retirement plans are generally subject to requirements regarding the form in which benefits may be paid without spousal consent.[172] The extent to which the requirements apply depends on the type of plan.

Defined benefit pension plans and money purchase pension plans[173] are generally 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 that 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 addition, if a married participant dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity ("QPSA"), which generally 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.[174]

The participant and his or her spouse may waive the right to a QJSA and QPSA if certain requirements are satisfied. In general, these requirements 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.

Defined contribution plans other than money purchase pension plans are generally not subject to the QJSA and QPSA rules unless the plan offers benefits in the form of an annuity and the participant elects an annuity. However, such defined contribution plans must provide that the participant's 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. In addition, the plan must not have received a transfer of assets from a plan to which the QJSA and QPSA requirements applied or must separately account for the transferred assets.

### REASONS FOR CHANGE

Present law requires defined benefit pension plans and money purchase pension plans to provide annuity benefits to a participant's surviving spouse unless the spouse consents to waive the annuity. The spousal consent rules provide important protections for spouses, particularly nonworking spouses. These rules also assist married employees and their spouses in determining how to meet their retirement income needs by requiring distributions in the form of a QJSA unless the participant and spouse consent to another form.

Most defined contribution plans do not offer benefits in the form of an annuity and thus are not subject to the QJSA and QPSA

[172] Code secs. 401(a)(11) and 417; ERISA sec. 205.

[173] A money purchase pension plan is a type of defined contribution plan that provides for a set level of required employer contributions, generally as a specified percentage of participants' compensation, and for the distribution of benefits in the form of an annuity.

[174] In the case of a money purchase pension plan, 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.

rules under present law. Requiring such plans to offer annuities (unless the participant and spouse elect otherwise) represents a significant policy change and is likely to increase administrative burdens for such plans. However, for many employees, a defined contribution plan is the only type of retirement plan offered by their employer. The Committee believes a study should be conducted on the feasibility and desirability of extending the spousal consent requirements to defined contribution plans.

### EXPLANATION OF PROVISION

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 are capable of authentication.

### EFFECTIVE DATE

The provision is effective on the date of enactment.

## B. DIVISION OF PENSION BENEFITS UPON DIVORCE

(Sec. 611 of the bill)

### 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.[175] One exception to the prohibition on assignment or alienation is a qualified domestic relations order ("QDRO").[176] A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee, including a former spouse, to any plan benefit payable with respect to a participant and that meets certain procedural requirements. In addition, a QDRO generally may not require the plan to provide any type or form of benefit, or any option, not otherwise provided under the plan, or to provide increased benefits.

Present law also provides that 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. This rule implicitly recognizes that a domestic relations order issued after a QDRO may also qualify as a QDRO. However, present law does not otherwise provide specific rules for the treatment of a domestic relations order as a QDRO if the order is issued after another domestic relations order

[175] Code sec. 401(a)(13); ERISA sec. 206(d).
[176] Code secs. 401(a)(13)(B) and 414(p); ERISA sec. 206(d)(3).

or a QDRO (including an order issued after a divorce decree) or revises another domestic relations order or a QDRO.

Present law provides specific rules that apply during any period in which the status of a domestic relations order as a QDRO is being determined (by the plan administrator, by a court, or otherwise). During such a period, the plan administrator is required to account separately for the amounts that would have been payable to the alternate payee during the period if the order had been determined to be a QDRO (referred to as "segregated amounts"). If, within the 18-month period beginning with the date on which the first payment would be required to be made under the order, the order (or modification thereof) is determined to be a QDRO, the plan administrator is required to pay the segregated amounts (including any interest thereon) to the person or persons entitled thereto. If, within the 18-month period, the order is determined not to be a QDRO, or its status as a QDRO is not resolved, the plan administrator is required to pay the segregated amounts (including any interest) to the person or persons who would be entitled to such amounts if there were no order. In such a case, any subsequent determination that the order is a QDRO is applied prospectively only.

### REASONS FOR CHANGE

The Committee understands that uncertainty exists under present law as to the treatment of certain domestic relations orders as QDROs, such as those that are issued subsequent to divorce or that revise a previous domestic relations order or QDRO. The Committee understands that issues as to whether a subsequent domestic relations order is a QDRO have arisen even in cases involving the same former spouse, such as a domestic relations order that deals with benefits not dealt with in a QDRO previously issued to the same former spouse. The Committee believes the treatment of such domestic relations orders should be clarified.

### EXPLANATION OF PROVISION

The Secretary of Labor is directed to issue, not later than one year after the date of enactment of the provision, regulations to clarify the status of certain domestic relations orders. In particular, the regulations are to 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. The regulations are also to clarify that such a domestic relations order is in all respects subject to the same requirements and protections that apply to QDROs. For example, as under present law, such a domestic relations order may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under an earlier QDRO. In addition, the present-law rules regarding segregated amounts that apply while the status of a domestic relations order as a QDRO is being determined continue to apply.

### EFFECTIVE DATE

The provision is effective on the date of enactment.

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

(Secs. 621 and 622 of the Act and secs. 2 and 5 of the Railroad Retirement Act of 1974)

### 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.

### REASONS FOR CHANGE

The Committee wishes to provide more equitable treatment of former spouses of railroad employees.

### EXPLANATION OF PROVISION

*Former spouses of living railroad employees*

The bill 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 bill 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 provisions are effective one year after the date of enactment.

## D. MODIFICATIONS OF JOINT AND SURVIVOR ANNUITY REQUIREMENTS

(Sec. 631 of the bill and secs. 401 and 417 of the Code and sec. 205 of ERISA)

### 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.[177] 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.[178] 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.

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),[179] 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.

[177] Code secs. 401(a)(11) and 417; ERISA sec. 205.

[178] Thus, a plan could provide an annuity for the life of the participant, with a survivor annuity for the life of the spouse equal to 75 percent of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

[179] 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.

REASONS FOR CHANGE

The Committee believes that it is appropriate to allow participants greater choice in selecting their form of benefits. The Committee believes that participants should have more options regarding their form of benefits so that they can determine the most appropriate option depending on the participant's individual circumstances. For example, some couples may prefer an option that pays a smaller benefit to the couple while they are both alive with a larger benefit to the surviving spouse.

EXPLANATION OF PROVISION

The provision revises the minimum survivor annuity requirements to require that, at the election of the participant, benefits will be paid in the form of a "qualified optional survivor annuity." A qualified optional survivor annuity means an annuity for the life of the participant with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity which is payable during the joint lives of the participant and the spouse and which is the actuarial equivalent of a single annuity for the life of the participant.

If the survivor annuity under plan's qualified joint and survivor annuity is less than 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 75 percent. If the survivor annuity under plan's qualified joint and survivor annuity is greater than or equal to 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 50 percent. Thus, for example, if the survivor annuity under the plan's qualified joint and survivor annuity is 50 percent, the survivor annuity under the qualified optional survivor annuity must be 75 percent.

The written explanation required to be provided to participants explaining the terms and conditions of the qualified joint and survivor annuity must also include the terms and conditions of the qualified optional survivor annuity.

Under the provision of the bill relating to plan amendments, a plan amendment made pursuant to a provision of the bill generally will not violate the anticutback rule if certain requirements are met (e.g., the plan amendment is made on or before the last day of the first plan year beginning on or after January 1, 2006). Thus, a plan is not treated as having decreased the accrued benefit of a participant solely by reason of the adoption of a plan amendment pursuant to the provision requiring that the plan offer a qualified optional survivor annuity. The elimination of a subsidized qualified joint and survivor annuity is not protected by the anticutback provision in the bill unless an equivalent or greater subsidy is retained in one of the forms offered under the plan as amended. For example, if a plan that offers a subsidized 50 percent qualified joint and survivor annuity is amended to provide an unsubsidized 50 percent qualified joint and survivor annuity and an unsubsidized 75 percent joint and survivor annuity as its qualified optional survivor annuity, the replacement of the subsidized 50 percent qualified joint and survivor annuity with the unsubsidized 50 percent qualified joint and survivor annuity is not protected by the anticutback protection.

EFFECTIVE DATE

The provision applies generally to plan years beginning after December 31, 2004. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision applies to plan years beginning on or after the earlier of (1) the later of January 1, 2005, and the last date on which an applicable collective bargaining agreement terminates (without regard to extensions), and (2) January 1, 2006.

## TITLE VII. TAX COURT PENSION AND COMPENSATION MODERNIZATION

### A. JUDGES OF THE TAX COURT

(Secs. 701–707 and 713 of the bill and secs. 7443, 7447, 7448, and 7472 of the Code)

PRESENT LAW

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[180] The salary of a Tax Court judge is the same salary as received by a U.S. District Court judge.[181] Present law also provides Tax Court judges with some benefits that correspond to benefits provided to U.S. District Court judges, including specific retirement and survivor benefit programs for Tax Court judges.[182]

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.

[180] Sec. 7441.
[181] Sec. 7443(c).
[182] Secs. 7447 and 7448.

REASONS FOR CHANGE

Tax Court judges receive compensation at the same rate as U.S. District Court judges. In addition, the benefit programs for Tax Court judges are intended to accord with similar programs applicable to U.S. District Court judges.[183] However, subsequent legislative changes in the benefits provided to U.S. District Court judges have not applied to Tax Court judges, thus creating disparities between the treatment of Tax Court judges and the treatment of U.S. District Court judges. The Committee believes that parity should exist between the benefits provided to Tax Court judges and those provided to U.S. District Court judges.

EXPLANATION OF PROVISION

*Survivor annuities for assassinated judges*

Under the provision, 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 provision 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.

*Life insurance coverage*

Under the provision, 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 Federal Employees Group Life Insurance 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,[184] 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 provision, 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 provision, 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.

[183] See, e.g., S. Rep. No. 91–552, at 303 (1969).
[184] 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 provision, 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 provisions are effective on the date of enactment, except that: (1) the provision 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 provision 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 provision relating to participation by Tax Court judges in the Thrift Savings Plan applies as of the next open season; and (4) the provision 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

(Secs. 708–713 of the bill, and sec. 7448 and new Secs. 7443A, 7443B, and 7443C of the Code)

PRESENT LAW

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.[185] The chief judge of the Tax Court may appoint special trial judges to handle certain cases.[186] 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.

REASONS FOR CHANGE

Special trial judges of the Tax Court perform a role similar to that of magistrate judges in courts established under Article III of the U.S. Constitution ("Article III" courts). However, disparities exist between the positions of magistrate judges of Article III courts and special trial judges of the Tax Court. For example, magistrate judges of Article III courts are appointed for a specific term, are subject to removal only in limited circumstances, and are eligible for coverage under special retirement and survivor benefit programs. The Committee believes that special trial judges of the Tax Court and magistrate judges of Article III courts should receive comparable treatment as to the status of the position, salary, and benefits.

[185] Sec. 7441.
[186] Sec. 7443A.

EXPLANATION OF PROVISION

*Magistrate judges of the Tax Court*

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

The provision 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 provision, 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 provision; (2) the date the judge takes office; or (3) the date the judge marries.

*Retirement annuity program for magistrate judges*

The provision 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 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 9½ years before the date of enactment of the provision. The provision 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.

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

The provision 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, under a court decree, a court order, or court-approved property settlement.

The provision 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 provision 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 provision, 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.

*Retirement annuity rule for incumbent magistrate judges*

The provision provides a transition rule for magistrate judges in active service on the date of enactment of the provision. 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 9½ years before the date of enactment of the provision and for which the magistrate judge makes contributions of one percent of salary.

*Recall of retired magistrate judges*

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

EFFECTIVE DATE

The provisions are effective on date of enactment.

# TITLE VIII. OTHER PROVISIONS

## A. TEMPORARY EXCLUSION FOR EDUCATION BENEFITS PROVIDED BY EMPLOYERS TO CHILDREN OF EMPLOYEES

(Sec. 801 of the bill and sec. 127 of the Code)

### PRESENT LAW

Up to $5,250 annually of employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan.[187] The exclusion does not apply with respect to education provided to an individual other than the employee, e.g., a child of the employee.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than five-percent owners of the employer (and their spouses and dependents).

### REASONS FOR CHANGE

The Committee believes that education is key to enabling Americans to remain competitive in the workforce and that employers should be encouraged to pay for the educational expenses of children of employees.

### EXPLANATION OF PROVISION

The provision provides that post-secondary educational benefits provided to children of employees are excludable from the gross income 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 $1,000. 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. The exclusion does not apply for employment tax purposes. The exclusion expires with respect to years beginning after December 31, 2005.

### EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2004, and before January 1, 2006.

[187] Employer-paid educational expenses of the employee that do not qualify for the section 127 exclusion may be excludable from gross income if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment.

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

(Sec. 802 of the bill and sec. 108 of the Code)

### PRESENT LAW

The National Health Service Corps Loan Repayment Program (the "NHSC Loan Repayment Program") provides education 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.

States may also provide for education loan repayment programs for persons who agree to provide primary health services in health professional shortage areas. Under the Public Health Service Act, such programs may receive Federal grants with respect to such repayment programs if certain requirements are satisfied.

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 or similar State programs under the Public Health Service Act are not specifically excluded from gross income, they are gross income to the recipient. There is also no exception from employment taxes (FICA and FUTA) for such loan repayments.

### REASONS FOR CHANGE

The Committee believes that elimination of the tax on loan repayments provided under the NHSC Loan Repayment Program and similar State programs will free up NHSC resources which are currently being used to pay for services that will be provided by medical professionals as a condition of loan repayment and improve the ability of the NHSC to attract medical professionals to underserved areas.

### EXPLANATION OF PROVISION

The provision excludes from gross income and employment taxes education loan repayments provided under the NHSC Loan Repayment Program and State programs eligible for funds under the Public Health Service Act.

### EFFECTIVE DATE

The provision is effective with respect to amounts received in taxable years beginning after December 31, 2004.

## C. Temporary Exclusion for Group Legal Services Benefits

(Sec. 803 of the bill and secs. 120 and 501(c)(20) of the Code)

### 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 of 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.[188] The exclusion is limited to an annual premium value of $70.

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.[189]

### REASONS FOR CHANGE

The Committee believes that it is appropriate to temporarily restore the exclusion for employer-provided group legal services without limiting the amount of the exclusion and to temporarily provide tax-exempt status for organizations which provide qualified group legal services.

### EXPLANATION OF PROVISION

The provision restores the exclusion for employer-provided group legal services for taxable years beginning after December 31, 2004, and before January 1, 2006. The amount of the exclusion is not limited. Additionally, for taxable years beginning after December 31, 2004, and before January 1, 2006, the provision provides tax-exempt status for organizations which provide qualified group legal services.

### EFFECTIVE DATE

The provision applies to taxable years beginning after December 31, 2004, and before January 1, 2006.

## D. Transfer of Funds From Black Lung Trust Fund to Combined Benefit Fund

(Sec. 804 of the bill and secs. 501(c)(21) and 9705 of the Code)

### PRESENT LAW

*Qualified black lung benefit trusts*

A qualified black lung benefit trust is exempt from Federal income taxation. Contributions to a qualified black lung benefit trust generally are deductible to the extent such contributions are necessary to fund the trust.

Under present law, no assets of a qualified black lung benefit trust may be used for, or diverted to, any purpose other than (1) to satisfy liabilities, or pay insurance premiums to cover liabilities,

[188] Sec. 120.
[189] Sec. 501(c)(20).

arising under the Black Lung Acts, (2) to pay administrative costs of operating the trust, (3) to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents (within certain limits) or (4) investment in Federal, State, or local securities and obligations, or in time demand deposits in a bank or insured credit union. Additionally, trust assets may be paid into the national Black Lung Disability Trust Fund, or into the general fund of the U.S. Treasury.

The amount of assets in qualified black lung benefit trusts available to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents may not exceed a yearly limit or an aggregate limit, whichever is less. The yearly limit is the amount of trust assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the preceding taxable year of the trust. The aggregate limit is the excess of the sum of the yearly limit as of the close of the last taxable year ending before October 24, 1992, plus earnings thereon as of the close of the taxable year preceding the taxable year involved over the aggregate payments for accident of health benefits for retired coal miners and their spouses and dependents made from the trust since October 24, 1992. Each of these determinations is required to be made by an independent actuary.

In general, amounts used to pay retiree accident or health benefits are not includible in the income of the company, nor is a deduction allowed for such amounts.

*United Mine Workers of America Combined Benefit Fund*

The United Mine Workers of America ("UMWA") Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for heath care from the private 1950 and 1974 UMWA Benefit Plans. The UMWA Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund.

REASONS FOR CHANGE

The Committee believes that better than expected market performance of black lung trust assets and fewer black lung claims have resulted in a situation where some coal companies have significant unanticipated excess assets in their black lung trusts. Removing the aggregate limit on the amount of black lung benefit trusts available to pay accident and health benefits or premiums for insurance exclusively covering such benefits for retired coal miners will allow coal companies to use greater amounts of their excess black lung trust assets to fund such benefits. Depositing the revenue raised by eliminating the aggregate limit into the UMWA Combined Benefit Fund will help to fund retired coal miners' health benefits.

EXPLANATION OF PROVISION

The provision eliminates the aggregate limit on the amount of excess black lung benefit trust assets that may be used to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents. In addition, under the provision, each fiscal year, the Secretary of the Treasury will transfer to the UMWA Combined Benefit Fund an amount which the Secretary estimates to be the additional amounts received in the Treasury for that fiscal year by reason of the elimination of the aggregate limit. The Secretary will adjust the amount transferred for any year to the extent necessary to correct errors in any estimate for any prior year. Any amount transferred to the UMWA Combined Benefit Fund under the provision will be used to proportionately reduce the unassigned beneficiary premium of each assigned operator for the plan year in which transferred.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2002.

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

(Sec. 420 of the Code, and secs. 101, 403 and 408 of ERISA)

PRESENT LAW[190]

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.[191] 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

[190] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Pension Equity Funding Act of 2004, Pub. L. No. 108–218 (April 10, 2004).

[191] Sec. 420.

in any taxable year. A qualified transfer may not be made from a multiemployer plan.

Excess assets generally means the excess, if any, of the value of the plan's assets[192] over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.[193] 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.[194]

No qualified transfer may be made after December 31, 2005.

REASONS FOR CHANGE

The Committee believes it is appropriate to extend the ability of employers to transfer assets set aside for pension benefits to a section 401(h) account for retiree health benefits as long as the security of employees' pension benefits is not thereby threatened.

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

[193] In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets 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), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

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

EXPLANATION OF PROVISION

[The bill does not include the provision relating to qualified transfers of excess defined benefit assets as approved by the Committee because an identical provision was enacted into law in the Pension Funding Equity Act of 2004 (Pub. L. No. 108–218) subsequent to Committee action on the bill. The following discussion describes the Committee action.]

The provision approved by the Committee would have allowed qualified transfers of excess defined benefit plan assets through December 31, 2013.[195]

EFFECTIVE DATE

The provision approved by the Committee would have been effective on the date of enactment.

## F. APPLICATION OF BASIS RULES TO NONRESIDENT ALIENS

(Sec. 811 of the bill and new sec. 72(w) of the Code)

PRESENT LAW

*Distributions from retirement plans*

Distributions from retirement plans are includible in gross income under the rules relating to annuities[196] 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 on an after-tax basis, 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 only 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.[197]

Employer contributions to retirement plans and other payments for labor or personal services performed outside the United States by a nonresident alien generally are not treated as U.S. source income. Such contributions, therefore, generally would not be includible in the nonresident alien's gross income if they had been paid directly to the nonresident alien at the time they were contributed. Consequently, the amounts of such contributions generally are includible in the employee's basis and are not taxed by the United States if a distribution is made when the employee is a U.S. citizen or resident.[198]

Earnings on contributions are not included in basis unless previously includible in income. In general, in the case of a nonexempt trust, earnings are includible in income when distributed or made available.[199] In the case of highly compensated employees, the

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[195] A separate provision of the bill allows qualified transfers for a certain multiemployer plan.
[196] Secs. 72 and 402.
[197] Sec. 72(f).
[198] Rev. Rul. 58–236, 1958–1 C.B. 37.
[199] Sec. 402(b)(2).

amount of the vested accrued benefit under the trust (other than the employee's investment in the contract) is generally required to be included in income annually (i.e., earnings are taxed as they accrue).[200]

*U.S. income tax treaties*

Under the 1996 U.S. Model Income Tax Treaty ("U.S. Model") and some U.S. income tax treaties in force, retirement plan 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. Under the U.S. Model 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 retirement plan's earnings, subsequent distributions to that person while a resident of the United States would not be taxable in the United States to the extent the distributions were attributable to such previously taxed amounts.

*Compensation of employees of foreign governments or international organizations*

Under section 893, wages, fees, and salaries of any employee of a foreign government or international organization (including a consular or other officer or a nondiplomatic representative) received as compensation for official services to the foreign government or international organization generally are excluded from gross income when (1) the employee is not a citizen of the United States, or is a citizen of the Republic of the Philippines (whether or not a citizen of the United States); (2) in the case of an employee of a foreign government, the services are of a character similar to those performed by employees of the United States in foreign countries; and (3) in the case of an employee of a foreign government, the foreign government grants an equivalent exemption to employees of the United States performing similar services in such foreign country. The Secretary of State certifies the names of the foreign countries which grant an equivalent exclusion to employees of the United States performing services in those countries, and the character of those services.

The exclusion does not apply to employees of controlled commercial entities or employees of foreign governments whose services are primarily in connection with commercial activity (whether within or outside the United States) of the foreign government.

REASONS FOR CHANGE

The Committee believes the present-law rules governing the calculation of basis provide an inflated basis in assets in retirement and similar arrangements for many individuals who become U.S. residents after accruing benefits under such arrangements. The Committee believes the ability of former nonresident aliens to receive tax-free distributions from such arrangements of amounts which have not been previously taxed is inconsistent with the tax-

[200] Sec. 402(b)(4).

ation of benefits paid to individuals who both accrue and receive distributions of benefits from such arrangements as U.S. residents (i.e., basis generally includes only previously-taxed amounts). The Committee believes that the present-law statutory rule which allows basis in contributions to such arrangements for individuals who become U.S. residents after they accrue benefits is inappropriate. While there is no comparable statutory provision providing basis for earnings, the Committee is aware that some taxpayers take the position that there is basis in the earnings on such contributions, even though such amounts have not been subject to tax. The Committee believes it is appropriate to provide more equitable taxation with respect to the distributions of both contributions and earnings from such arrangements.

EXPLANATION OF PROVISION

The provision modifies the present-law rules under which certain contributions and earnings that have not been previously taxed are treated as basis. Under the provision, employee or employer contributions are not included in basis if: (1) the employee was a nonresident alien at the time the services were performed with respect to which the contribution was made; (2) the contribution is with respect to compensation for labor or personal services from sources without the United States; and (3) the contribution was not subject to income tax under the laws of the United States or any foreign country.

Similarly, under the provision, earnings on employer or employee contributions are not included in basis if: (1) the earnings are paid or accrued with respect to any employer or employee contributions which were made with respect to compensation for labor or personal services; (2) the employee was a nonresident alien at the time the earnings were paid or accrued; and (3) the earnings were not subject to income tax under the laws of the United States or any foreign country. No inference is intended that under present law there is basis for earning not previously subject to tax.

The provision does not change the rules applicable to calculation of basis with respect to contributions or earnings while an employee is a U.S. resident. For example, suppose employer contributions were made to a retirement plan on behalf of an individual (E) while the individual was a nonresident alien. The contributions were not subject to income tax in the United States or a foreign country. Suppose the contributions are in a discriminatory nonexempt trust so that earnings on the trust would be taxable to E if E were a United States resident; however, because E is a nonresident alien, E is not subject to tax on the earnings. Suppose E then relocates to the United States and becomes a U.S. resident, during which time earnings on the trust are taxable under the rules requiring income inclusion of vested accrued amounts for highly compensated employees. E's basis does not include the employer contributions, nor any earnings paid or accrued while E was a nonresident alien. E's basis will include the earnings includible in gross income while E was a U.S. resident.

There is no inference that this provision applies in any case to create tax jurisdiction with respect to wages, fees, and salaries otherwise exempt under section 893. Similarly, there is no inference that this provision applies where contrary to an agreement of the

United States that has been validly authorized by Congress (or in the case of a treaty, ratified by the Senate), and which provides an exemption for income.

Most U.S. tax treaties specifically address the taxation of pension distributions. The U.S. Model treaty provides for exclusive residence-based taxation of pension distributions to the extent such distributions were not previously included in taxable income in the other country. For treaty purposes, the United States treats any amount that has increased the recipient's basis (as defined in section 72) as having been previously included in taxable income. The following example illustrates how the provision could affect the amount of a distribution that may be taxed by the United States pursuant to a tax treaty.

Assume the following facts. A, a nonresident alien individual, performs services outside the United States. A's employer makes contributions on behalf of A to a pension plan established in A's country of residence, Z. For U.S. tax purposes, no portion of the contributions or earnings are included in A's gross income because such amounts relate to services performed without the United States.[201] Later in time, A retires and becomes a resident alien of the United States.

Under the provision, the employer contributions to the pension plan would not be taken into account in determining A's basis unless A was subject to income tax on the contributions by a foreign country. If A was not subject to tax on such amounts by a foreign country, A would be subject to U.S. tax on the entire amount of contributions. Earnings that accrued while A was a nonresident alien would be subject to the provision. Earnings that accrued while A was a resident of the United States would be subject to present-law rules. This result is consistent with the treatment of pension distributions under the U.S. Model treaty, which provides for residence-based taxation only to the extent such amounts have not been taxed previously by the treaty partner.

Even though A is a resident alien under U.S. statutory rules, if A is a resident of country Y, with which the United States has an income tax treaty (including a pension provision identical to the U.S. Model) and A qualifies for benefits as a resident of Y under the U.S.-Y treaty, A would be subject to U.S. tax on the distributions only to the extent the amounts were not previously included in A's taxable income in country Y. Thus, if Y had taxed A on the employer contributions or the earnings of the plan, distributions attributable to these previously taxed amounts would not be subject to U.S. income tax pursuant to the U.S.-Y tax treaty. On the other hand, if Z rather than Y had taxed A on the employer contributions or earnings of the plan, the pension provision in the U.S.-Y treaty would not apply.

The provision authorizes the Secretary of the Treasury to issue regulations to carry out the purposes of this provision, including regulations treating contributions as not subject to income tax under the laws of any foreign country under appropriate circumstances. For example, Treasury could provide that foreign income tax that was merely nominal would not satisfy the "subject to income tax" requirement.

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[201] Sec. 872.

EFFECTIVE DATE

The provision is effective for distributions occurring on or after the date of enactment. No inference is intended that the earnings subject to the provision are included in basis under present law.

## G. Modify Qualification Rules for Tax-Exempt Property and Casualty Insurance Companies and Modify Definition of Insurance Company for Property and Casualty Insurance Company

(Secs. 501(c)(15) and 831(b) and (c) of the Code)

PRESENT LAW [202]

*Qualification rules*

A property and casualty insurance company generally is subject to tax on its taxable income (sec. 831(a)). The taxable income of a property and casualty insurance company is determined as the sum of its underwriting income and investment income (as well as gains and other income items), reduced by allowable deductions (sec. 832).

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).

*Definition of insurance company*

Present law provides specific rules for taxation of the life insurance company taxable income of a life insurance company (sec. 801), and for taxation of the taxable income of an insurance company other than a life insurance company (sec. 831) (generally referred to as a property and casualty insurance company). For Federal income tax purposes, a life insurance company means an insurance company that is engaged in the business of issuing life insurance and annuity contracts, or noncancellable health and accident insurance contracts, and that meets a 50-percent test with respect to its reserves (sec. 816(a)). This statutory provision applica-

[202] Present law refers to the law in effect on the dates of Committee action on the bill. It does not reflect the changes made by the Pension Funding Equity Act of 2004, Pub. L. No. 108–218 (April 10, 2004).

ble to life insurance companies explicitly defines the term "insurance company" to mean 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)).

The life insurance company statutory definition of an insurance company does not explicitly apply to property and casualty insurance companies, although a long-standing Treasury regulation[203] that is applied to property and casualty companies provides a somewhat similar definition of an "insurance company" based on the company's "primary and predominant business activity."[204]

When enacting the statutory definition of an insurance company in 1984, Congress stated, "[b]y requiring [that] more than half rather than the 'primary and predominant business activity' be insurance activity, the bill adopts a stricter and more precise standard for a company to be taxed as a life insurance company than does the general regulatory definition of an insurance company applicable for both life and nonlife insurance companies * * * Whether more than half of the business activity is related to the issuing of insurance or annuity contracts will depend on the facts and circumstances and factors to be considered will include the relative distribution of the number of employees assigned to, the amount of space allocated to, and the net income derived from, the various business activities."[205]

REASONS FOR CHANGE

The Committee has become aware of abuses in the area of tax-exempt insurance companies. Considerable media attention has focused on the inappropriate use of tax-exempt insurance companies

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[203] The Treasury regulation provides that "the term 'insurance company' means a company whose primary and predominant business activity during the taxable year is the issuing of insurance or annuity contracts or the reinsuring of risks underwritten by insurance companies. Thus, though its name, charter powers, and subjection to State insurance laws are significant in determining the business which a company is authorized and intends to carry on, it is the character of the business actually done in the taxable year which determines whether a company is taxable as an insurance company under the Internal Revenue Code." Treas. Reg. section 1.801–3(a)(1).

[204] Court cases involving a determination of whether a company is an insurance company for Federal tax purposes have examined all of the business and other activities of the company. In considering whether a company is an insurance company for such purposes, courts have considered, among other factors, the amount and source of income received by the company from its different activities. See *Bowers* v. *Lawyers Mortgage Co.,* 285 U.S. 182 (1932); *United States* v. *Home Title Insurance Co.,* 285 U.S. 191 (1932). See also *Inter-American Life Insurance Co.* v. *Comm'r,* 56 T.C. 497, aff'd per curiam, 469 F.2d 697 (9th Cir. 1972), in which the court concluded that the company was not an insurance company: "The * * * financial data clearly indicates that petitioner's primary and predominant source of income was from its investments and not from issuing insurance contracts or reinsuring risks underwritten by insurance companies. During each of the years in issue, petitioner's investment income far exceeded its premiums and the amounts of earned premiums were de minimis during those years. It is equally as clear that petitioner's primary and predominant efforts were not expended in issuing insurance contracts or in reinsurance. Of the relatively few policies directly written by petitioner, nearly all were issued to [family members]. Also, Investment Life, in which [family members] each owned a substantial stock interest, was the source of nearly all of the policies reinsured by petitioner. These facts, coupled with the fact that petitioner did not maintain an active sales staff soliciting or selling insurance policies * * *, indicate a lack of concentrated effort on petitioner's behalf toward its chartered purpose of engaging in the insurance business. * * * For the above reasons, we hold that during the years in issue, petitioner was not 'an insurance company * * * engaged in the business of issuing life insurance' and hence, that petitioner was not a life insurance company within the meaning of section 801." 56 T.C. 497, 507–508.

[205] H.R. Rep. 98–432, part 2, at 1402–1403 (1984); S. Prt. No. 98–169, vol. I, at 525–526 (1984); *see also* H.R. Rep. No. 98–861 at 1043–1044 (1985) (Conference Report).

to shelter investment income.[206] The Committee believes that the use of these organizations as vehicles for sheltering income was never contemplated by Congress. The proliferation of these organizations as a means to avoid tax on income, sometimes on large investment portfolios, is inconsistent with the original narrow scope of the provision, which has been in the tax law for decades. The Committee believes it is necessary to limit the availability of tax-exempt status under the provision so that it cannot be abused as a tax shelter. To that end, the bill applies a gross receipts test and requires that premiums received for the taxable year be greater than 50 percent of gross receipts.

The bill correspondingly expands the availability of the present-law election of a property and casualty insurer to be taxed only on taxable investment income to companies with premiums below $350,000. This provision of present law provides a relatively simple tax calculation for small property and casualty insurers, and because the election results in the taxation of investment income, the Committee does not believe that it is abused to avoid tax on investment income. Thus, the bill provides that a company whose net written premiums (or if greater, direct written premiums) do not exceed $1.2 million (without regard to the $350,000 threshhold of present law) is eligible for the simplification benefit of this election.

The Committee believes that the law will be made clearer and more exact and tax administration will be improved by conforming the definition of an insurance company for purposes of the property and casualty insurance tax rules to the existing statutory definition of an insurance company under the life insurance company tax rules. Further, the Committee expects that IRS enforcement activities to prevent abuse of the provision relating to tax-exempt insurance companies will be simplified and improved by this provision of the bill.

EXPLANATION OF PROVISION

[The bill does not include the provisions relating to qualification rules for an insurance company to be eligible for tax-exempt status, to elect to be taxed on taxable investment income and defining an insurance company for these purposes, as approved by the Committee, because substantially similar provisions[207] were enacted

[206] See David Cay Johnston, *Insurance Loophole Helps Rich,* N.Y. Times, April 1, 2003; David Cay Johnston, *Tiny Insurers Face Scrutiny as Tax Shields,* N.Y. Times, April 4, 2003, at C1; Janet Novack, *Are You a Chump?,* Forbes, Mar. 5, 2001.

[207] Section 206 of PFEA 2004 modifies the requirements for a property and casualty insurance company to be eligible for tax-exempt status, providing that the company's gross receipts may not exceed $600,000 and premiums received for the taxable year are required to be greater than 50 percent of its gross receipts. Section 206 of PFEA 2004 also provides that a property and casualty 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. Section 206 of PFEA 2004 modifies the definition of an insurance company for purposes of these rules to mean 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. Section 206 of PFEA 2004 provides an additional special rule (not included in the this bill) that a mutual property and casualty insurance company is eligible to be exempt from Federal income tax under the provision if (a) its gross receipts for the taxable year do not exceed $150,000, and (b) the premiums received for the taxable year are greater than 35 percent of its gross receipts, provided certain requirements are met. Section 206 of PFEA provision generally is effective for taxable years beginning after December 31, 2003, except that a special transition rule (not included in this bill) is provided with respect to certain companies. This transition rule applies in the case of a company that, (1) for its taxable year that includes April 1, 2004, meets the requirements of present-law section 501(c)(15)(A) (as in effect for the taxable year beginning before January 1, 2004), and (2) on April 1, 2004, is in a receivership, liquidation or similar proceeding under the supervision of a State court. Under the transition rule, in the

into law in the Pension Funding Equity Act of 2004 (Pub. L. No. 108–218) subsequent to Committee action on the bill. The following discussion describes the Committee action.]

*Qualification rules*

The provision in the bill would have modified 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.

The provision would have provided that 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 provision would have expanded the present-law controlled group rule so that it also takes into account gross receipts of foreign and tax-exempt corporations.

The provision also would have provided 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.

*Definition of insurance company*

The provision would have provided that a company that does not meet the definition of an insurance company is not eligible to be exempt from Federal income tax. 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) and new sec. 831(c)). A company whose investment activities outweigh its insurance activities is not considered to be an insurance company for this purpose.[208] It is intended that IRS enforcement activities address the misuse of present-law section 501(c)(15). The provision would have conformed the definition of an insurance company for purposes of the rules taxing property and casualty insurance companies to the rules taxing life insurance companies, so that the definition is uniform. The provision would have adopted a stricter and more precise standard than the "primary and predominant business activity" test contained in

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case of such a company, the provision applies to taxable years beginning after the earlier of (1) the date the proceeding ends, or (2) December 31, 2007.

[208] 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).

Treasury Regulations. It is not intended that a company whose sole activity is the run-off of risks under the company's insurance contracts be treated as a company other than an insurance company, even if the company has little or no premium income.

EFFECTIVE DATE

The provisions would have been effective for taxable years beginning after December 31, 2003.

## H. Tax Treatment of Company-Owned Life Insurance ("COLI")

(Secs. 812 and 813 of the bill and new secs. 101(j) and 6039I of the Code)

PRESENT LAW

*Amounts received under a life insurance contract*

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.[209] No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).[210]

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.[211]

*Premium and interest deduction limitations*[212]

*Premiums*

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.[213]

*Interest paid or accrued with respect to the contract*

No deduction generally is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual.[214] An exception is provided under this provision for insurance of key persons.

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[209] Sec. 101(a).

[210] This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

[211] Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

[212] In addition to the statutory limitations described below, interest deductions under company-owned life insurance arrangements have also been limited by recent cases applying general principles of tax law. See *Winn-Dixie Stores, Inc.* v. *Commissioner,* 113 T.C. 254 (1999), aff'd *254 F.3d 1313 (11th Cir. 2001),* cert. denied, *April 15, 2002; Internal Revenue Service* v. *CM Holdings, Inc.,* 254 B.R. 578 (D. Del. 2000), aff'd, *301 F.3d 96 (3d Cir. 2002); American Electric Power, Inc.* v. *U.S.,* 136 F.Supp. 2d 762 (S. D. Ohio 2001), aff'd, *326 F.3d 737 (6th Cir. 2003),* reh. denied, *338 F.3d 534 (6th Cir. 2003),* cert. denied, *U.S. No. 03–529 (Jan. 12, 2004);* but see *Dow Chemical Company* v. *U.S.,* 250 F. Supp.2d 748 (E.D. Mich. 2003), modified, *Case No. 00–10331–BC, E. D. Mich., Aug. 12, 2003.*

[213] Sec. 264(a)(1).

[214] Sec. 264(a)(4).

Interest that is otherwise deductible (e.g., is not disallowed under other applicable rules or general principles of tax law) may be deductible under the key person exception, to the extent that the aggregate amount of the debt does not exceed $50,000 per insured individual. The deductible interest may not exceed the amount determined by applying a rate based on a Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.[215]

*Pro rata interest limitation*

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.[216] Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers an individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

*"Single premium" and "4-out-of-7" limitations*

Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.[217] In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).[218] Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the "4-out-of-7 rule").

*Definitions of highly compensated employee*

Present law defines highly compensated employees and individuals for various purposes. For purposes of nondiscrimination rules

[215] Sec. 264(e)(3).
[216] Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.
[217] Sec. 264(a)(2).
[218] Sec. 264(a)(3).

relating to qualified retirement plans, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of $90,000 (for 2004) or (b) at the election of the employer had compensation in excess of $90,000 (for 2004) and was in the highest paid 20 percent of employees for such year.[219] The $90,000 dollar amount is indexed for inflation.

For purposes of nondiscrimination rules relating to self-insured medical reimbursement plans, a highly compensated individual is an employee who is one of the five highest paid officers of the employer, a shareholder who owns more than 10 percent of the value of the stock of the employer, or is among the highest paid 25 percent of all employees.[220]

REASONS FOR CHANGE

The Committee is aware of companies who have, in the past, purchased insurance on rank-and-file employees and collect the proceeds years after the employee terminated employment with the company. To curtail this practice, when proceeds are payable more than 12 months after termination of employment, the bill excludes from income only proceeds on policies purchased on the lives of directors and highly compensated individuals, including the highest-paid 35 percent of employees.

The Committee is also aware of reports that in some cases the insured employee is not aware that his or her life has been insured. The Committee believes that it is important for employers to provide notice to insured employees and to obtain the consent of employees to be insured, and consequently, the bill imposes notice and consent requirements in order for the exceptions to the income inclusion rule to apply.

In order to aid compliance with the provisions and facilitate IRS enforcement, the bill also imposes recordkeeping requirements with respect to employer-owned life insurance contracts issued after the date of enactment.

EXPLANATION OF PROVISION

The provision provides generally that, in the case of an employer-owned life insurance contract, the amount excluded from the applicable policyholder's income as a death benefit cannot exceed the premiums and other amounts paid by such applicable policyholder for the contract. The excess death benefit is included in income.

Exceptions to this income inclusion rule are provided. In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured individual who, with respect to the applicable policyholder, was an employee at any time during the 12-month period before the insured's death, or who, at the time the contract was issued, was a director or highly compensated em-

[219] Sec. 414(q). For purposes of determining the top-paid 20 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

[220] Sec. 105(h)(5). For purposes of determining the top-paid 25 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

ployee or highly compensated individual. For this purpose, such a person is one who is either: (1) a highly compensated employee as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees; or (2) a highly compensated individual as defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35 percent of employees for the highest-paid 25 percent of employees.[221]

In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured, to the extent the amount is (1) paid to a member of the family[222] of the insured, to an individual who is the designated beneficiary of the insured under the contract (other than an applicable policyholder), to a trust established for the benefit of any such member of the family or designated beneficiary, or to the estate of the insured; or (2) used to purchase an equity (or partnership capital or profits) interest in the applicable policyholder from such a family member, beneficiary, trust or estate. It is intended that such amounts be so paid or used by the due date of the tax return for the taxable year of the applicable policyholder in which they are received as a death benefit under the insurance contract, so that the payment of the amount to such a person or persons, or the use of the amount to make such a purchase, is known in the taxable year for which the exception from the income inclusion rule is claimed.

An employer-owned life insurance contract is defined for purposes of the provision as a life insurance contract which (1) is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary, and (2) covers the life of an individual who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

An applicable policyholder means, with respect to an employer-owned life insurance contract, the person (including related persons) that owns the contract, if the person is engaged in a trade or business, and if the person (or a related person) is directly or indirectly a beneficiary under the contract.

For purposes of the provision, a related person includes any person that bears a relationship specified in section 267(b) or 707(b)(1)[223] or is engaged in trades or businesses that are under common control (within the meaning of section 52(a) or (b)).

The notice and consent requirements of the provision are met if, before the issuance of the contract, (1) the employee is notified in writing that the applicable policyholder intends to insure the employee's life, and is notified of the maximum face amount at issue

[221] As under present law, certain employees are disregarded in making the determinations regarding the top-paid groups.

[222] For this purpose, a member of the family is defined in section 267(c)(4) to include only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

[223] The relationships include specified relationships among family members, shareholders and corporations, corporations that are members of a controlled group, trust grantors and fiduciaries, tax-exempt organizations and persons that control such organizations, commonly controlled S corporations, partnerships and C corporations, estates and beneficiaries, commonly controlled partnerships, and partners and partnerships. Detailed rules apply to determine the specific relationships.

of the life insurance contract that the employer might take out on the life of the employee, (2) the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (3) the employee is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable on the death of the employee.

For purposes of the provision, an employee includes an officer, a director, and a highly compensated employee; an insured means, with respect to an employer-owned life insurance contract, an individual covered by the contract who is a U.S. citizen or resident. In the case of a contract covering the joint lives of two individuals, references to an insured include both of the individuals.

The provision requires annual reporting and recordkeeping by applicable policyholders that own one or more employer-owned life insurance contracts. The information to be reported is (1) the number of employees of the applicable policyholder at the end of the year, (2) the number of employees insured under employer-owned life insurance contracts at the end of the year, (3) the total amount of insurance in force at the end of the year under such contracts, (4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which it is engaged, and (5) a statement that the applicable policyholder has a valid consent (in accordance with the consent requirements under the provision) for each insured employee and, if all such consents were not obtained, the total number of insured employees for whom such consent was not obtained. The applicable policyholder is required to keep records necessary to determine whether the requirements of the reporting rule and the income inclusion rule of new section 101(j) are met.

## EFFECTIVE DATE

The amendments made by this section generally apply to contracts issued after the date of enactment, except for contracts issued after such date pursuant to an exchange described in section 1035 of the Code. In addition, certain material increases in the death benefit or other material changes will generally cause a contract to be treated as a new contract, with an exception for existing lives under a master contract. Increases in the death benefit that occur as a result of the operation of section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract. In addition, certain changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued.

Examples of situations in which death benefit increases would not cause a contract to be treated as a new contract include the following:

(1) Section 7702 provides that life insurance contracts need to either meet the cash value accumulation test of section 7702(b) or the guideline premium requirements of section 7702(c) and the cash value corridor of section 7702(d). Under the corridor test, the amount of the death benefit may not be less than the applicable

percentage of the cash surrender value. Contracts may be written to comply with the corridor requirement by providing for automatic increases in the death benefit based on the cash surrender value. Death benefit increases required by the corridor test or the cash value accumulation test do not require the insurer's consent at the time of increase and occur in order to keep the contact in compliance with section 7702.

(2) Death benefits may also increase due to normal operation of the contract. For example, for some contracts, policyholder dividends paid under the contract may be applied to purchase paid-up additions, which increase the death benefits. The insurer's consent is not required for these death benefit increases.

(3) For variable contacts and universal life contracts, the death benefit may increase as a result of market performance or the contract design. For example, some contracts provide that the death benefit will equal the cash value plus a specified amount at risk. With these contracts, the amount of the death benefit at any time will vary depending on changes in the cash value of the contract. The insurance company's consent is not required for these death benefit increases.

## I. REPORTING OF TAXABLE MERGERS AND ACQUISITIONS

(Sec. 813 of the bill and new sec. 6043A of the Code)

### PRESENT LAW

Under section 6045 and the regulations thereunder, brokers (defined to include stock transfer agents) are required to make information returns and to provide corresponding payee statements as to sales made on behalf of their customers, subject to the penalty provisions of sections 6721–6724. Under the regulations issued under section 6045, this requirement generally does not apply with respect to taxable transactions other than exchanges for cash (e.g., stock inversion transactions taxable to shareholders by reason of section 367(a)).

### REASONS FOR CHANGE

The Committee believes that administration of the tax laws would be improved by greater information reporting with respect to taxable non-cash transactions, and that the Treasury Secretary's authority to require such enhanced reporting should be made explicit in the Code.

### EXPLANATION OF PROVISION

Under the provision, if gain or loss is recognized in whole or in part by shareholders of a corporation by reason of a second corporation's acquisition of the stock or assets of the first corporation, then the acquiring corporation (or the acquired corporation, if so prescribed by the Treasury Secretary) is required to make a return containing:

(1) A description of the transaction;

(2) The name and address of each shareholder of the acquired corporation that recognizes gain as a result of the transaction (or would recognize gain, if there was a built-in gain on the shareholder's shares);

(3) The amount of money and the value of stock or other consideration paid to each shareholder described above; and

(4) Such other information as the Treasury Secretary may prescribe.

Alternatively, a stock transfer agent who records transfers of stock in such transaction may make the return described above in lieu of the second corporation.

In addition, every person required to make a return described above is required to furnish to each shareholder (or the shareholder's nominee [224]) whose name is required to be set forth in such return a written statement showing:

(1) The name, address, and phone number of the information contact of the person required to make such return;

(2) The information required to be shown on that return; and

(3) Such other information as the Treasury Secretary may prescribe.

This written statement is required to be furnished to the shareholder on or before January 31 of the year following the calendar year during which the transaction occurred.

The present-law penalties for failure to comply with information reporting requirements are extended to failures to comply with the requirements set forth under the provision.

#### EFFECTIVE DATE

The provision is effective for acquisitions after the date of enactment.

## III. BUDGET EFFECTS OF THE BILL

### A. COMMITTEE ESTIMATES

In compliance with paragraph 11(a) of rule XXVI of the Standing Rules of the Senate, the following statement is made concerning the estimated budget effects of the provisions of the bill as reported.

[224] In the case of a nominee, the nominee must furnish the information to the shareholder in the manner prescribed by the Secretary of the Treasury.

**ESTIMATED BUDGET EFFECTS OF**
**THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT,"**
**AS REPORTED BY THE COMMITTEE ON FINANCE**

**Fiscal Years 2004 - 2013**

***[Millions of Dollars]***

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2004-08 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| **Diversification of Pension Plan Assets** | **generally pyba 12/31/03 & DOE** | *Negligible Revenue Effect* | | | | | | | | | | | |
| **Information to Assist Pension Plan Participants [1]** | **various** | **---** | **-12** | **-19** | **-22** | **-24** | **-27** | **-7** | **---** | **---** | **---** | **-78** | **-112** |
| **Protection of Pension Plan Participants** | **various** | *Negligible Revenue Effect* | | | | | | | | | | | |
| **Other Provisions Relating to Pensions** | | | | | | | | | | | | | |
| A. Provisions Relating to Pension Plan Funding | | | | | | | | | | | | | |
| 1. Replacement of interest rate on 30-year Treasury securities used for certain pension plan purposes and other funding provisions [2] [3] | generally pyba 12/31/03 | 577 | 940 | 2,564 | 2,492 | 106 | -398 | -882 | -1,699 | -2,020 | -2,224 | 6,680 | -543 |
| 2. Update deduction rules for combination plans | cf tyba 12/31/04 | --- | -12 | -24 | -30 | -30 | -30 | -30 | -30 | -30 | -30 | -96 | -246 |
| B. Improvements in Portability and Distribution Provisions | | | | | | | | | | | | | |
| 1. Purchase of permissive service credit | [4] | *Negligible Revenue Effect* | | | | | | | | | | | |
| 2. Rollover of after-tax amounts | tyba 12/31/04 | *Negligible Revenue Effect* | | | | | | | | | | | |
| 3. Application of minimum distribution rules to governmental plans | DOE | *No Revenue Effect* | | | | | | | | | | | |
| 4. Inapplicability of 10% additional tax on early distributions from pension plans of public safety employees | da DOE | [5] | -2 | -3 | -3 | -3 | -3 | -3 | -3 | -4 | -4 | -10 | -27 |
| 5. Allow rollovers by nonspouse beneficiaries of certain retirement plan distributions | dma 12/31/04 | --- | -8 | -24 | -32 | -35 | -32 | -28 | -24 | -21 | -17 | -99 | -222 |
| 6. Faster vesting of employer nonelective contributions | generally cf pyba 12/31/04 | *Negligible Revenue Effect* | | | | | | | | | | | |
| 7. Allow direct rollovers from retirement plans to Roth IRAs | dma 12/31/04 | *Negligible Revenue Effect* | | | | | | | | | | | |
| 8. Elimination of higher early withdrawal tax on certain SIMPLE distributions | yba 12/31/04 | --- | [5] | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -1 | -3 | -8 |
| 9. SIMPLE plan portability | yba 12/31/04 | *Negligible Revenue Effect* | | | | | | | | | | | |
| 10. Eligibility for participation in section 457 plans | DOE | *Negligible Revenue Effect* | | | | | | | | | | | |
| 11. Benefit transfers to the PBGC [6] | [7] | *Estimate to be Provided by the Congressional Budget Office* | | | | | | | | | | | |
| C. Administrative Provisions | | | | | | | | | | | | | |
| 1. Improvement of employee plans compliance resolution system | DOE | *Negligible Revenue Effect* | | | | | | | | | | | |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2004-08 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules applicable to State and local government plans | pyba 12/31/04 | Negligible Revenue Effect | | | | | | | | | | | |
| 3. Notice and consent period regarding distributions | yba 12/31/04 | Negligible Revenue Effect | | | | | | | | | | | |
| 4. Pension plan reporting simplification | generally pybo/a 1/1/04 | No Revenue Effect | | | | | | | | | | | |
| 5. Missing participants [6] | dma fripp | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] |
| 6. Reduced PBGC premiums for small and new plans [8] | pfea 12/31/04 & pyba 12/31/04 | --- | [5] | -3 | -5 | -6 | -7 | -7 | -7 | -8 | -8 | -14 | -51 |
| 7. Authorization for PBGC to pay interest on premium overpayment refunds [6] | iafpbnet DOE | -2 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -3 | -14 | -29 |
| 8. Rules for substantial owner benefits in terminated plans [6] | [9] | --- | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] |
| 9. Voluntary early retirement incentive and employment retention plans maintained by local educational agencies and other entities | generally DOE | -2 | -4 | -7 | -9 | -11 | -11 | -11 | -11 | -11 | -11 | -33 | -88 |
| 10. Acceleration of PBGC computation of benefits attributable to recoveries from employers [6] | noitto/a 30da DOE | Negligible Revenue Effect | | | | | | | | | | | |
| 11. Multiemployer plan funding and solvency notices [3] | pyba 12/31/05 | No Revenue Effect | | | | | | | | | | | |
| 12. No reduction in unemployment compensation as a result of pension rollovers [6] | wbo/a DOE | Estimate to be Provided by the Congressional Budget Office | | | | | | | | | | | |
| 13. Withholding on certain distributions from 457 governmental eligible deferred compensation plans | [7] | -3 | 1 | 1 | [10] | [10] | [10] | [10] | [10] | [10] | [10] | -1 | [5] |
| 14. Minimum cost requirement for excess asset transfers | tyea DOE | Negligible Revenue Effect | | | | | | | | | | | |
| D. Studies | DOE | No Revenue Effect | | | | | | | | | | | |
| E. Other Provisions | | | | | | | | | | | | | |
| 1. Additional IRA catch-up contributions for certain individuals (sunset for taxable years beginning after 12/31/08) | tyba 12/31/03 | -1 | -3 | -4 | -6 | -7 | -6 | -3 | -3 | -3 | -3 | -21 | -38 |
| 2. Distributions by an S corp to an employee stock ownership plan | 1/1/98 | [5] | [5] | [5] | [5] | [5] | [5] | [5] | [5] | -1 | -1 | -2 | -5 |
| 3. Allow transfers of excess pension plan assets to multiemployer retiree health plan | tyba 12/31/04 | --- | [10] | [10] | [10] | [10] | [10] | [10] | [10] | [10] | [10] | 2 | 4 |
| F. Plan amendments | DOE | No Revenue Effect | | | | | | | | | | | |
| **Total of Other Provisions Relating to Pensions** | | **569** | **909** | **2,496** | **2,403** | **10** | **-491** | **-968** | **-1,781** | **-2,102** | **-2,302** | **6,389** | **-1,253** |
| **Provisions Relating to Executives and Stock Options** | | | | | | | | | | | | | |
| A. Provisions Relating to Executives | | | | | | | | | | | | | |
| 1. Repeal of limitation on issuance of Treasury guidance regarding nonqualified deferred compensation | tyba DOE | Negligible Revenue Effect | | | | | | | | | | | |
| 2. Include in income certain nonqualified deferred compensation, including compensation funded with assets located outside the United States | adi tyba 12/31/04 | -5 | 133 | 122 | 42 | 21 | 20 | 18 | 139 | 182 | 167 | 313 | 839 |
| 3. Deferral of certain stock option and restricted stock option gains prohibited [11] | after 12/31/04 | --- | 11 | 6 | 2 | 1 | 1 | 1 | 5 | 7 | 6 | 20 | 40 |
| 4. Increase in withholding from supplemental wage payments in excess of $1 million | pma 12/31/03 | 99 | 12 | 44 | 5 | [10] | [10] | [10] | 4 | 7 | 8 | 159 | 178 |
| B. Stock Options | | | | | | | | | | | | | |
| 1. Exclusion of incentive stock options and employee stock purchase plan stock options from wages | DOE | No Revenue Effect | | | | | | | | | | | |

| Provision | Effective | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2004-08 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|---|
| 2. Capital gain treatment on sale of stock acquired from exercise of statutory stock options to comply with conflict-of-interest requirements | sa DOE | [10] | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 1 | 3 | 6 |
| **Total of Provisions Relating to Executives and Stock Options** | | **94** | **157** | **173** | **50** | **23** | **22** | **20** | **149** | **197** | **182** | **495** | **1,063** |
| **Women's Pension Protection Provisions** | | | | | | | | | | | | | |
| A. Joint Study of Application of Spousal Consent Rules to Defined Contribution Plans | DOE | *No Revenue Effect* | | | | | | | | | | | |
| B. Treatment of Subsequent Qualified Domestic Relations Orders | DOE | *Negligible Revenue Effect* | | | | | | | | | | | |
| C. Protection of Rights of Former Spouses Under the Railroad Retirement System [6] | 1ya DOE | --- | [5] | [5] | [5] | -1 | -1 | -1 | -1 | -2 | -2 | -2 | -10 |
| D. Modifications of Joint and Survivor Annuity Requirements | generally pyba 12/31/04 | *Negligible Revenue Effect* | | | | | | | | | | | |
| **Total of Women's Pension Protection Provisions** | | **[12]** | **[5]** | **[5]** | **[5]** | **-1** | **-1** | **-1** | **-1** | **-2** | **-2** | **-2** | **-10** |
| **Tax Court Pension and Compensation Modernization Provisions [13] [14]** | **generally DOE** | **-3** | **[5]** | **[5]** | **[5]** | **[5]** | **[5]** | **[5]** | **[5]** | **[5]** | **-1** | **-4** | **-6** |
| **Other Provisions** | | | | | | | | | | | | | |
| A. General Provisions | | | | | | | | | | | | | |
| 1. Exclusion for postsecondary educational benefits provided by an employer to children of of employees (sunset 12/31/05) | tyba 12/31/04 | --- | -130 | -44 | --- | --- | --- | --- | --- | --- | --- | -174 | -174 |
| 2. Exclude from gross income and employment taxes payments made to individuals under NHSC Loan Repayment Program and certain State loan repayment programs | tyba 12/31/04 | --- | -1 | -2 | -2 | -4 | -5 | -6 | -8 | -11 | -14 | -9 | -53 |
| 3. Temporary exclusion for group legal services benefits (sunset 12/31/05) | tyba 12/31/04 | --- | -85 | -34 | --- | --- | --- | --- | --- | --- | --- | -119 | -119 |
| 4. Transfer of funds from Black Lung Trust Fund to Combined Benefit Fund [15] | tyba 12/31/02 | *The Net Effect of Revenues and Outlays is Negligible* | | | | | | | | | | | |
| B. Revenue Provisions | | | | | | | | | | | | | |
| 1. Application of basis rules to nonresident aliens | doo/a DOE | 2 | 12 | 13 | 14 | 15 | 15 | 16 | 16 | 17 | 17 | 56 | 137 |
| 2. Modify the taxation of death benefits for certain employer-owned life insurance contracts | cia DOE | *Negligible Revenue Effect* | | | | | | | | | | | |
| 3. Reporting of taxable mergers and acquisitions | aa DOE | 1 | 2 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 3 | 12 | 27 |
| **Total of Other Provisions** | | **3** | **-202** | **-64** | **15** | **14** | **13** | **13** | **11** | **9** | **6** | **-234** | **-182** |
| **NET TOTAL** | | **663** | **852** | **2,586** | **2,446** | **22** | **-484** | **-943** | **-1,622** | **-1,898** | **-2,117** | **6,566** | **-500** |

Joint Committee on Taxation

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NOTE: Details may not add to totals due to rounding.

*[Legend and Footnotes for the Table appear on the following page]*

**Legend and Footnotes for the Table:**

Legend for "Effective" column:

aa = acquisitions after
adi = amounts deferred in
cf = contributions for
cia = contracts issued after
da = distributions after
DOE = date of enactment
doo/a = distributions occurring on or after
dma = distributions made after
fripp = final regulations implementing the provision are prescribed
iafpbnet = interest accruing for periods beginning not earlier than
noitto/a = notice of intent to terminate on or after
pfea = plans first effective after
pma = payments made after
pyba = plan years beginning after
pybo/a = plan years beginning on or after
sa = sales after
tyba = taxable years beginning after
yba = years beginning after
wbo/a = weeks beginning on or after
30da = 30 days after
1ya = 1 year after

[1] Revenue loss is associated with the provision relating to treatment of qualified retirement planning services. This provision is effective for taxable years beginning after December 31, 2004 and before January 1, 2010.
[2] Estimate does not include effects on PBGC variable-rate premiums, which are the responsibility of the Congressional Budget Office.
[3] H.R. 3108, the "Pension Funding Equity Act of 2004" (P.L. 108-218) contains related provisions. The estimate of this provision reflects the enactment of H.R. 3108.
[4] Generally effective as if included in the amendments made by section 1526(a) of the Taxpayer Relief Act of 1997, except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Act of 2001.
[5] Loss of less than $500,000.
[6] Estimate reflects outlay effects provided by the Congressional Budget Office.
[7] Effective as if included in the Economic Growth and Tax Relief Reconciliation Act of 2001.
[8] Estimate provided by the Congressional Budget Office. PBGC premiums are offsetting collections to a mandatory spending account, thus reductions (increases) in premium receipts are reflected as increases (decreases) in direct spending.
[9] 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, 2004.
[10] Gain of less than $500,000.
[11] Estimate includes interaction with item 2.
[12] Negligible revenue effect.
[13] Certain portions of the estimate were provided by the Congressional Budget Office.

| | 2004 | 2005 | 2006 | 2007 | 2008 | 2009 | 2010 | 2011 | 2012 | 2013 | 2004-08 | 2004-13 |
|---|---|---|---|---|---|---|---|---|---|---|---|---|
| [14] Includes the following increase in outlay effects ....................................................... | 3 | [10] | [10] | [10] | [10] | [10] | [10] | [10] | [10] | [10] | 3 | 5 |

[15] The provision eliminates aggregate limit on the amount of excess black lung benefit trust assets that may be used to pay accident and health benefits for coal miners. Revenue raised by the provision will be deposited into the UMWA Combined Benefit Fund. The net effect, including both the revenue raised and the outlay effects provided by the Congressional Budget Office, is negligible.

### B. Budget Authority and Tax Expenditures

*Budget authority*

In compliance with section 308(a)(1) of the Budget Act, the Committee states that the provisions of section 710 of the bill involve new or increased budget authority with respect to the Tax Court Judicial Officers' Retirement Fund.

*Tax expenditures*

In compliance with section 308(a)(2) of the Budget Act, the Committee states that the revenue-reducing provisions of the bill involve increased tax expenditures (see revenue table in Part III.A., above). The revenue increasing provisions of the bill generally involve reduced tax expenditures (see revenue table in Part III.A., above).

### C. Consultation With Congressional Budget Office

In accordance with section 403 of the Budget Act, the Committee advises that the Congressional Budget Office has not submitted a statement on the bill. The letter from the Congressional Budget Office has not been received, and therefore will be provided separately.

## IV. VOTES OF THE COMMITTEE

In compliance with paragraph 7(b) of rule XXVI of the Standing Rules of the Senate, the following statements are made concerning the votes taken on the Committee's consideration of the bill.

*Motion to report the bill*

The bill, as modified and amended, was originally ordered favorably reported by voice vote, a quorum being present, on September 17, 2003. After consideration of further modifications and amendments, the bill, as modified and amended, was ordered favorably reported by voice vote, a quorum being present, on February 2, 2004.

*Votes on amendments*

The Committee accepted an amendment by Senator Bingaman relating to company-owned life insurance ("COLI") on September 17, 2003. The Committee also accepted an amendment by Senator Santorum relating to transfers from the Black Lung Disability Trust Fund.

## V. REGULATORY IMPACT AND OTHER MATTERS

### A. Regulatory Impact

Pursuant to paragraph 11(b) of rule XXVI of the Standing Rules of the Senate, the Committee makes the following statement concerning the regulatory impact that might be incurred in carrying out the provisions of the bill as amended.

*Impact on individuals and businesses*

The bill includes provisions relating to qualified retirement plans, including provisions designed to increase retirement income security by (1) providing employees with greater opportunity to diversify plan investments in employer securities, (2) requiring plans to provide additional information with respect to plan benefits and investments, (3) clarifying fiduciary requirements under ERISA, and (4) improving employees' retirement savings opportunities, portability, and spousal protections. The bill also includes a variety of provisions intended to reduce administrative burdens on employers with regard to pension plans, including provisions relating to required funding contributions, reductions of Pension Benefit Guaranty Corporation premiums for certain plans, transfers of excess assets to retiree health accounts, and other plan administration issues. The bill also includes directives for a number of studies relating to specific issues that affect retirement income security. Some of these provisions may impose additional administrative requirements on employers that sponsor retirement plans; however, in some cases the employer may avoid application of the provisions through plan design. In addition, some of the provisions will reduce regulatory burdens on employers that sponsor retirement plans.

The bill includes provisions relating to certain executive compensation arrangements and the proper tax treatment of such arrangements. These provisions may impose additional administrative requirements on employers; however, the employer may avoid application of the provisions through the design of these arrangements.

The bill includes various other provisions that are not expected to impose additional administrative requirements or regulatory burdens on individuals or businesses.

*Impact on personal privacy and paperwork*

The provisions of the bill do not impact personal privacy.

Some provisions of the bill relating to pension plans will reduce paperwork burdens on employers that sponsor qualified retirement plans. Other provisions may impose additional burdens on employers; however, in many cases an employer may reduce such burdens through plan design. The provision regarding withholding requirements with respect to certain stock options will reduce regulatory burdens on individuals and businesses that may currently apply withholding to these options. Certain provisions provide additional tax benefits to individuals or businesses, such as the provisions relating to additional catch-up contributions, the sale of stock to comply with conflict of interest rules, and exclusions of educational benefits and group legal services. These provisions may require individuals and businesses that seek to take advantage of these tax benefits to maintain records to demonstrate eligibility for the tax benefits.

## B. Unfunded Mandates Statement

This information is provided in accordance with section 423 of the Unfunded Mandates Reform Act of 1995 (P.L. 104–4).

The Committee has determined that the revenue provisions of the bill do not contain Federal mandates on the private sector. The Committee has determined that the revenue provisions of the bill do not impose a Federal intergovernmental mandate on State, local, or tribal governments.

## C. Tax Complexity Analysis

Section 4022(b) of the Internal Revenue Service Reform and Restructuring Act of 1998 (the "IRS Reform Act") requires the Joint Committee on Taxation (in consultation with the Internal Revenue Service and the Department of the Treasury) to provide a tax complexity analysis. The complexity analysis is required for all legislation reported by the Senate Committee on Finance, the House Committee on Ways and Means, or any committee of conference if the legislation includes a provision that directly or indirectly amends the Internal Revenue Code (the "Code") and has widespread applicability to individuals or small businesses.

The staff of the Joint Committee on Taxation has determined that a complexity analysis is not required under section 4022(b) of the IRS Reform Act because the bill contains no provisions that amend the Code and that have "widespread applicability" to individuals or small businesses.

# VI. ADDITIONAL VIEWS

## ADDITIONAL VIEWS OF SENATOR CONRAD

I am pleased that as a result of the efforts of Chairman Grassley, Senator Baucus, other members of the Committee on Finance, and the Department of the Treasury, the bill includes a provision on corporate-owned life insurance (COLI) that preserves COLI as a valuable tool for employers to use in providing a dependable funding source for their employee benefit liabilities while at the same time addressing important concerns that had been expressed about the product.

As a result of the Committee's balanced COLI legislation, no employer will be able to exclude from income the death benefits from a policy purchased after enactment on the life of a rank-and-file employee or on the life of an employee who has not given informed, voluntary consent to the employer's purchase of the life insurance. No one will be able to criticize COLI as "janitors' insurance" anymore.

Under the Committee's bill, future COLI purchases will require that the employer notify the employee in writing that the employer intends to insure the employee's life and that the employer will be the beneficiary of the life insurance. The employer must also disclose to the employee how much the maximum death benefit under the policy will be at the time of issuance (i.e., not taking into account normal future death benefit increases resulting from policy performance, tax rules, or otherwise). This stronger disclosure rule incorporates a recommendation that Senator Bingaman and I made to provide better information to employees whom the employer seeks to insure.

More importantly, the Committee's bill will also condition tax-free death benefits from future COLI purchases on the employee's advance written consent to being insured and to having the insurance coverage continue after the employee terminates his or her employment with the employer. The employee's consent to be insured must, of course, be voluntary. During its consideration of legislation on COLI, the Committee learned that there are no known instances of employers coercing employee consent or retaliating for the failure to provide consent. However, if such coercion or retaliation were to occur after enactment of the Committee's COLI provision, I believe the Congress should consider whether there should be a remedy in labor law to deter and punish such actions.

I would like to emphasize the importance that I and other members of the Finance Committee attached to the valuable role COLI now plays in providing a tool to offset employee benefit costs, including retiree health promises. The Committee continues to hear disturbing stories about companies that are shedding their retiree health liabilities because of cost concerns.[225] I hope that continued availability of COLI will help to slow this trend of retiree health benefit reductions. I believe the Committee's COLI provision should encourage employers willing to abide by its clear rules to consider the purchase of COLI in situations where it would constitute an appropriate funding mechanism for employee benefit obligations.

KENT CONRAD.

[225] "Companies Limit Health Coverage of Many Retirees," New York Times, Feb. 3, 2004.

## ADDITIONAL VIEWS OF SENATOR BINGAMAN

Although I support the majority of this report, I must respectfully state my objections to the provisions pertaining to company owned life insurance (COLI). This language is a replacement for a meaningful amendment that was originally negotiated and agreed to by the Committee during the initial mark up of the bill. Instead of reporting out the bill as agreed to that day, the Committee kept the bill in limbo for several months before replacing the COLI provisions agreed upon by the Committee with alternative language. Unfortunately, this new language does nothing to curb any of the existing abuses nor prevent future ones from occurring.

As I have noted previously, the core problem with COLI is that the uses of this product have moved well beyond what was ever intended by Congress. The tax benefits associated with this product—tax free inside buildup and tax-free death benefits—were intended to aid families and those with a significant financial risk of loss upon the untimely passing of the insured. This product is now sold in a variety of situations where the owners of the policy have little or no risk of financial loss on the passing of the insured. For example, companies who take out policies on the lives of employees routinely keep those policies long after the insured has left the employment of the company. This occurs even when the former employee has severed all ties with the company and is not entitled to any benefit from the company. This was never the intent of Congress nor does it make for rational tax policy.

Although companies claim that they purchase the product to offset the cost of employee benefits, such as retiree health care, the fact is that companies can use the proceeds of these tax favored policies for any use. Most commonly, the policies are used to "fund" deferred compensation arrangements or executive benefits packages—benefits for which Congress has expressly not provided a tax benefit to businesses. In fact, Congress has created disincentives in the Tax Code to discourage the use of these arrangements. For example, companies are not allowed a deduction for the payment of deferred compensation until the employee includes the payment as taxable income.

Congress has explicitly provided tax benefits for employers to provide employee benefits, such as qualified retirement plans, health insurance and life insurance owned by the employee. Unlike COLI, the companies are only eligible to receive these tax benefits if they take an affirmative act to provide these benefits to the majority of their employees—not just the more highly compensated. In most cases, the funds must be placed in a trust for the benefit of the employee or the employer must transfer the rights to these benefits to the employee. Not with COLI. With COLI, a company is able to use the proceeds of these tax preferenced policies for anything it chooses. The money is not set aside or dedicated to any specific use—it is totally up to the discretion of the company as to how to use the funds. The insured or their beneficiaries are not entitled to any of these life insurance policies.

Although a company is not required to use the proceeds for any specific purpose, the product is most often marketed as a funding mechanism for deferred compensation arrangements or executive perquisites. Such a use undermines our country's qualified retirement plan system that is premised on the concept that employers should receive tax incentives to provide retirement benefits, but only if the majority of workers can benefit. COLI competes with this reward system and pushes us closer to a two-tiered retirement system in this country—one type of plans for workers and an additional layer of plans for the executives. Both of these types of plans are subsidized by all taxpayers, not just the ones that benefit. This is the wrong approach and it reverses so much of what we have achieved over the past decades. Ultimately, it makes it more likely that a large segment of workers will not have adequate savings upon which to retire. The Committee should be focusing on reducing this inequity, not allowing it to expand.

The proponents of COLI argue that the language contained in this report address the abuses in COLI. This can only be true if one believes that the current uses of COLI are appropriate tax policy. This is evidenced by the revenue estimate from the Joint Committee on Taxation that this new provision has a negligible revenue effect. Essentially this means that the Joint Committee on Taxation has estimated that there will be no change in the purchases or uses of this product based on this language. This is in direct contrast to the original agreed upon language that would reduce abuses by over $1 billion over ten years.

Inexplicably, the notice and consent that is required in this language does little to protect the rights of employees, as employers are free to fire or not hire employees who do not wish to give their consent. In almost every other area of labor law, we provide employees with protections, such as those contained in ERISA, from retaliatory firings. I offered an amendment to correct this seemingly clear potential violation of employee rights, but this amendment was not accepted. I fail to understand how an employee is better off being dismissed for not consenting to have an insurance policy taken out on his or her life than if the company purchased the policy without the employee's consent. If it was intended that employees' rights not to consent be truly voluntary, some form of protection would need to be included.

I also fail to understand the Committee's rationale in setting up a procedure that can not be enforced by the IRS. The current language requires a company to have a valid consent in order to receive the death benefit on the life of the insured tax free yet the time between the purchase of the policy and the death of the insured could be years, if not decades. Worse, the IRS will not even be notified of the death of the insured or the receipt of the death benefits by the company that owns the policy. Quite simply, there is no way the IRS will ever be able to connect these two pieces of information to determine if a company is in compliance. As the IRS has demonstrated that it is unable to enforce the myriad laws currently in effect, it is inconceivable that they will be able to handle these new responsibilities.

I am confident that the issues I have raised will need to be addressed in the future by this Committee. The tax benefits associated with COLI are simply too great to be ignored as evidenced by current abuses. As this report is being filed, stories are already circulating evidencing additional abuses with charities and churches buying COLI policies and selling them to investors. It is important to note that nothing in this report will have an impact on these types of policies. With deficits continuing to climb, I assume that this Committee will eventually need to make real choices about tax policy. At that point, I look forward to working with the insurance industry and my colleagues to come up with a rational policy that allows life insurance to continue to prosper, but in a way that does not foster such abuses.

JEFF BINGAMAN.

## VII. CHANGES IN EXISTING LAW MADE BY THE BILL AS REPORTED

In the opinion of the Committee, it is necessary in order to expedite the business of the Senate, to dispense with the requirements of paragraph 12 of rule XXVI of the Standing Rules of the Senate (relating to the showing of changes in existing law made by the bill as reported by the Committee).