TECHNICAL EXPLANATION OF THE REVENUE PROVISIONS OF H.R. 3762, THE “PENSION SECURITY ACT OF 2002”

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a technical explanation of the revenue provisions of H.R. 3762, the "Pension Security Act of 2002" (an amendment in the nature of a substitute for the reported bill), which is scheduled for consideration by the House of Representatives on April 11, 2002.

[1] This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of the Revenue Provisions of H.R. 3762, the "Pension Security Act of 2002"* (JCX-24-02), April 11, 2002.

TITLE I: IMPROVEMENTS IN PENSION PLAN SECURITY

A. Provide Investment Education Notices to Participants in Certain Plans (sec. 101(b) of the bill and new secs. 414(w) and 6652(m) of the Code)

Present Law

Present law does not require that participants be given specific information relating to investment education.

Explanation of Provision

The provision requires the plan administrator of certain plans to provide investment education notices to applicable individuals. The requirement applies to qualified retirement plans (sec. 401(a)), qualified annuity plans (sec. 403(a)), tax-sheltered annuities (sec. 403(b)), and governmental eligible deferred compensation plans (sec. 457) that (1) permit a participant to direct the investment of his or her account or under which a participant's accrued benefit depends on hypothetical investments directed by the participant (including a defined benefit plan) and (2) are not subject to section 105 of the Employee Retirement Income Security Act of 1974 ("ERISA").

The investment education notice must be provided on enrollment in the plan and at least annually thereafter.[2] Applicable individuals are plan participants, alternate payees under a qualified domestic relations order, and beneficiaries of a deceased participant or alternate payee. The notice requirement does not apply to one-person plans.[3]

The investment education notice is required to contain an explanation, for the long-term retirement security of participants and beneficiaries, of generally accepted investment principles, including risk management and diversification, and a discussion of the risk of holding substantial portions of a portfolio in securities of any one entity, such as employer securities.

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[2] The right to direct investments includes the right of an applicable individual in an employee stock ownership plan to direct the investment of a portion of his or her account under present law and the right of an applicable individual to direct the plan to divest the individual's account of employer securities as provided under another provision of the bill.

[3] A one-person plan is a plan that (1) on the first day of the plan year, covers 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, (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.

The notice must be written in a manner calculated to be understood by the average plan participant and provide sufficient information (as determined under Treasury guidance) to allow recipients to understand the notice. The notice is required to be in writing and may be provided in electronic or other form (or electronically posted on the plan's website) to the extent that such form is reasonably accessible to the applicable individual.

A penalty is imposed on a plan administrator that fails to provide the required investment education notice. The penalty is $100 per failure per applicable individual; the maximum amount of penalty that can be imposed on the plan administrator for all failures during a calendar year is $50,000. No penalty is imposed if the failure is due to reasonable cause and not to willful neglect.

Effective Date

The provision is generally effective for plan years beginning on or after January 1, 2003, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement under section 109 of the bill.

B. Excise Tax on Failure to Provide Notice to Participants of Transaction Restriction Periods (sec. 102(b) of the bill and new sec. 4980H of the Code)

Present Law

Present law does not require that participants be given advance notice of temporary periods during which the ability to direct investments or to obtain loans or distributions from the plan is restricted.

Explanation of Provision

In general

Under the provision, a qualified retirement plan or annuity, a tax-sheltered annuity plan, or an eligible deferred compensation plan of a governmental employer is required to provide advance notice of a transaction restriction period to applicable individuals to whom the transaction restriction period applies. The notice must be provided to such individuals at least 30 days before the beginning of the transaction restriction period. Applicable individuals include plan participants, alternate payees under a qualified domestic relations order, and beneficiaries of a deceased participant or alternate payee.

The notice requirement applies to a plan that maintains accounts for participants or a plan (including a defined benefit plan) under which a participant's accrued benefit depends in whole or in part on hypothetical investments directed by the participant. The notice requirement does not apply to one-person plans.[4]

Definition of transaction restriction period

A transaction restriction period means a period during which certain rights are substantially reduced (other than because of the application of securities laws or other circumstances specified in regulations) if the rights are not restored by the third day after the rights are reduced. A transaction restriction period may occur with respect to the right under the plan of one or more applicable individuals to direct investments, or obtain loans or distributions from the plan. For this purpose, rights are treated as substantially reduced with respect to directing investments out of employer securities if rights are significantly restricted for at least three consecutive business days. In the case of a publicly-traded security, "business day" means any day on which the security may be traded on its principal market, and, in the case of a security that is not publicly traded, "business day" means any calendar day.

Whether an individual's right to direct investments or obtain loans or distributions from the plan is substantially reduced, or whether the right to direct investments out of employer securities is significantly restricted, is generally determined by reference to the normal rights and procedures provided under the plan. A variety of factors may be relevant in making this

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[4] The term "one-person plan" is defined as under the provision of the bill relating to investment education notices (sec. 101 of the bill).

determination. For example, if, in connection with a change in plan recordkeepers, no investment directions, loans, or distributions can be executed over a three-day weekend (i.e., a Saturday, a Sunday, and a Monday that is a Federal holiday), then no transaction restriction period results if the participants would not, under the terms of the plan, have been able to engage in such transactions during that period in any event. In addition, if a plan provides that a participant's ability to make investment changes, or obtain a loan or a distribution, is limited for a certain period in connection with a qualified domestic relations order with respect to the participant's account, that limitation generally does not result in a transaction restriction period. Factors in addition to the time period involved may also be relevant. For example, suppose a plan offers a variety of investment options, including three options that have similar characteristics (e.g., similar risk and return characteristics). If the ability to transfer funds into only one of these options is restricted, this may not result in a transaction restriction period for purposes of the provision, because participants have the right to transfer funds into similar investment options.

Timing of notice

Notice of a transaction restriction period generally has to be provided at least 30 days before the beginning of the period. If there is the possibility of a transaction restriction period in connection with a major corporate disposition by a corporation maintaining the plan, the notice must be provided at least 30 days before the date of the disposition. Advance notice is not required if the plan administrator has a substantial basis to believe that no transaction restriction period will occur. If notice is provided at least 30 days before the disposition, no other notice is required if the transaction restriction period begins within 30 days after the disposition. A "major corporate disposition" means the disposition of substantially all of the stock of the corporation, or a subsidiary thereof, or the disposition of substantially all of the assets used in a trade or business of the corporation or subsidiary. Similar rules apply in the case of an entity that is not a corporation.

It is intended that participants will be given the opportunity to execute investment changes with respect to their accounts, or obtain loans or distributions otherwise permitted under the plan, before the transaction restriction period begins.

Form of notice

Notice of a transaction restriction period has to be written in a manner calculated to be understood by the average plan participant and provide sufficient information (as determined under Treasury guidance) to allow the recipients to understand the timing and effect of the transaction restriction period. The notice is required to be provided in writing and may be provided in electronic or other form to the extent that such form is reasonably accessible to the applicable individual.

Excise tax

In the case of a failure to comply with the notice requirement, an excise tax of $100 for each applicable individual with respect to whom the failure occurred is generally imposed on the employer.[5] 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 is imposed with respect to a failure if the employer exercises reasonable diligence to comply and the failure is corrected as soon as reasonably practicable and at least one business day before the beginning of the transaction restriction period. No tax is imposed if, in the case of an unforeseeable event, it is not reasonably practicable to provide notice before the beginning of the transaction restriction period. 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 provision is generally effective for plan years beginning on or after January 1, 2003, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement under section 109 of the bill. The Secretary of the Treasury, in consultation with the Secretary of Labor, is required to issue guidance for carrying out the new notice requirements within 120 days after the date of enactment. Guidance concerning a reduction of rights relating to the direction of investments out of employer securities is required to be issued by November 1, 2002 (or within 60 days after the date of enactment, if later).

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

C. Diversification Requirements for Defined Contribution Plans that Hold Employer Securities (sec. 104(b) of the bill and new sec. 401(a)(35) of the Code)

Present Law

In general

Whether and the extent to which present law places limits on defined contribution plan investment in employer securities depends on the type of plan.

Diversification requirements applicable to employee stock ownership plans ("ESOPs")

Under the Internal Revenue 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. The diversification requirement applies to a participant for six years, starting with the year in which the individual firsts meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if (1) the plan distributes the applicable amount to the participant within 90 days after the election period, (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election, or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[6]

10-percent limit on the acquisition of employer securities

ERISA prohibits money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer stock.[7] This 10-percent limitation does not apply to other types of defined contribution plans. Thus, most defined contribution plans, such as profit-sharing plans, stock bonus plans, and ESOPs, are not subject to any limit on the amount of employer securities that can be invested in employer securities. In addition, a fiduciary generally is deemed not to violate the requirement that plan

[6] Code sec. 401(a)(28); IRS Notice 88-56, 1988-1 CB 540, Q&A 16.

[7] This 10-percent limitation also applies to defined benefit plans.

assets be diversified with respect to the acquisition or holding of employer securities in such plans.[8]

Under ERISA, the 10-percent limitation on the acquisition of employer securities, described above, applies separately to the portion of a plan consisting of elective deferrals (and earnings thereon) if any portion of an individual's elective deferrals (or earnings thereon) are required to be invested in employer securities 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 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.

Explanation of Provision

In general

Under the bill, defined contribution plans that hold employer securities are generally required to permit applicable individuals at least quarterly to direct that the portion of the individual's account held in employer securities be invested in alternative investments. In order to satisfy this diversification requirement, applicable individuals must be given a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. Other investment options offered by the plan generally must also be available. The definition of applicable individual who must be permitted to diversify depends on the type of contribution involved.

The diversification requirement does not apply to a defined contribution plan holding employer securities if there is no class of stock issued by the employer (or a member of the employer's controlled group) that is publicly traded (i.e., readily tradable on an established securities market). It is intended that the Secretary will exercise general interpretive authority to identify exceptions to the diversification requirements in appropriate cases. For example, an exception may be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer's controlled group has issued a limited amount of publicly-traded stock.

The diversification requirement does not apply to an ESOP unless the ESOP holds contributions (or earnings thereon) that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions. The present-law ESOP diversification rules no longer apply to an ESOP that is subject to the requirements of the bill (i.e., an ESOP that holds elective deferrals, employee after-tax contributions, matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests (or earnings thereon) and that is maintained by a publicly-traded company).

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8 Under ERISA, plans that are not subject to the 10-percent limitation on the acquisition of employer securities are referred to as "eligible individual account plans."

Elective deferrals and employee contributions

In the case of elective deferrals under a qualified cash or deferred arrangement and employee after-tax contributions, an applicable individual means (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. Thus, in the case of all participants and such beneficiaries, the portion of the account attributable to elective deferrals and employee after-tax contributions held in employer securities is subject to the diversification requirements.

Other contributions

In the case of all other contributions, the diversification requirements apply in the case of an applicable individual with a benefit based on three years of service. For this purposes, an applicable individual has a benefit based on three years of service if the individual is (1) a participant with three years of service,[9] or (2) a beneficiary with respect to a participant with three years of service if the beneficiary has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

An alternative is available for satisfying the diversification requirements with respect to the portion of an individual's account attributable to contributions other than elective deferrals and employee after-tax contributions that is held in employer securities. Under the alternative, the time when an applicable individual must be permitted to diversify that portion of the account is based on when the employer securities were allocated to the account. Diversification must be permitted no later than the last day of the third plan year after the plan year in which the allocation occurred. For example, if employer securities are allocated to an applicable individual's account in July 2008, and the plan year is the calendar year, the individual must be permitted no later than December 31, 2011, to make a diversification election with respect to the employer securities. The provision does not preclude the three-year period from being measured more frequently than annually. For example, the plan may provide diversification rights with respect to employer securities as of the end of the calendar quarter that occurs three years after the calendar quarter in which the securities were allocated to the account.

Transition rule

The provision includes a transition rule for the first five years for which the new diversification requirements apply to a plan. Under the transition rule, in the case of employer securities held in the plan on the first day on which the diversification requirements apply to the plan, diversification rights generally must be provided with respect to the applicable percentage as shown in the following table.

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

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

Plan year for which diversification applies:	Applicable percentage:
First year	Greater of amount that would be required under present-law ESOP diversification rule or 20 percent
Second year...........................	Greater of amount that would be required under present-law ESOP diversification rule or 40 percent
Third year..............................	60 percent
Fourth year............................	80 percent
Fifth year or thereafter	100 percent

The applicable percentage is reduced to the extent necessary to reflect any previous diversification of employer securities pursuant to an election under the present-law ESOP diversification requirements.

The applicable percentage is 100 percent with respect to employer securities attributable to employee after-tax contributions and elective deferrals (and earnings thereon) held in a plan under which the elective deferrals are treated as a separate plan for purposes of the ERISA 10-percent limitation on the acquisition of employer securities. The determination of whether elective deferrals are treated as a separate plan and thus are subject to the 100 percent diversification rule (rather than the phase-in) is made as of the date of enactment.

Effective Date

The provision is generally effective for plan years beginning after December 31, 2002, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement under section 109 of the bill, and applies with respect to employer securities allocated before, on, or after the date of enactment of the provision. The provision does not apply to employer securities held by an ESOP that are acquired before January 1, 1987 (and thus are not subject to the present-law diversification requirement).

D. Prohibited Transaction Exemption for the Provision of Investment Advice (sec. 105(b) of the bill and sec. 4975 of the Code)

Present Law

Present law prohibits certain transactions between an employee benefit plan and a disqualified person. Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Prohibited transactions include (1) the sale, exchange or leasing of property, (2) the lending of money or other extension of credit, (3) the furnishing of goods, services or facilities, (4) the transfer to, or use by or for the benefit of, the income or assets of the plan, (5) in the case of a fiduciary, any act that deals with the plan's income or assets for the fiduciary's own interest or account, and (6) the receipt by a fiduciary of any consideration for the fiduciary's own personal account from any party dealing with the plan in connection with a transaction involving the income or assets of the plan. However, certain transactions are exempt from prohibited transaction treatment, for example, certain loans to plan participants.

If a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. The prohibited transaction rules apply to a qualified retirement plan, a qualified retirement annuity, an individual retirement account or annuity, an Archer MSA, or a Coverdell education savings account.

Explanation of Provision

The provision adds a new category of prohibited transaction exemptions in connection with the provision of investment advice with respect to plan assets for a fee if (1) the investment of plan assets is subject to the direction of plan participants or beneficiaries, (2) the advice is provided to the plan or a participant or beneficiary by a fiduciary advisor in connection with a sale, acquisition or holding of a security or other property (an "investment transaction") for purposes of investment of plan assets, and (3) certain other requirements are met. Under the provision, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice to the plan, participant or beneficiary, (2) an investment transaction (including any lending of money or other extension of credit associated with the investment transaction) pursuant to the advice, and (3) the direct or indirect receipt of fees or other compensation by a fiduciary advisor or affiliate (or any employee, agent or registered representative of the fiduciary advisor or affiliate) in connection with the provision of the advice or an investment transaction pursuant to the advice.

Under the provision, certain requirements must be met in order for the exemption to apply. When initially providing advice about a security or other property, the fiduciary advisor must provide to the recipient of the advice, on a reasonably contemporaneous basis, written notification of specified information (discussed below) as well as any disclosure required in connection with the investment transaction under any applicable securities laws. In addition, the investment transaction must occur solely at the direction of the recipient of the advice; the compensation received by the advisor and affiliates in connection with the investment transaction must be reasonable; and the terms of the investment transaction must be at least as favorable as an arm's length transaction would be.

The written notification required to be provided by the fiduciary advisor must include information about the following: (1) all fees or compensation to be received by the advisor or an affiliate (including from a third party) in connection with the advice or the investment transaction, (2) any material affiliation or contractual relationship of the advisor or affiliates in the security or other property involved in the investment transaction, (3) any limitation to be placed on the scope of the investment advice, (4) the types of services provided by the advisor in connection with the provision of investment advice, (5) the advisor's status as a fiduciary of the plan in connection with the provision of the advice, and (6) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. The written notification can be provided electronically. In addition, in connection with the initial advice or subsequent advice, the required information must be provided in currently accurate form at least annually and also when requested by the recipient of the advice and when there is a material change in the information. Any notification (or currently accurate information) must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and be sufficiently accurate and comprehensive reasonably to apprise participants and beneficiaries of the required information.

The fiduciary advisor must maintain for at least six years any records necessary for determining whether the requirements for the prohibited transaction exemption were met. A prohibited transaction will not be considered to have occurred merely because records were lost or destroyed before the end of six years due to circumstances beyond the advisor's control.

For purposes of the provision, "fiduciary advisor" is defined as a person who is a fiduciary of the plan by reason of the provision of investment advice to the plan, a participant or beneficiary and who is also (1) registered as an investment advisor under the Investment Advisors Act of 1940 or under State laws, (2) a bank or similar financial institution supervised by the United States or a State, but only if the advice is provided through a trust department that is subject to periodic examination and review by Federal or State banking authorities, (3) an insurance company qualified to do business under State law, (4) registered as a broker or dealer under the Securities Exchange Act of 1934, (5) an affiliate of any of the preceding, or (6) an employee, agent or representative of any of the preceding who satisfies the requirements of applicable insurance, banking and securities laws relating to the provision of advice. "Affiliate" means an affiliated person as defined under section 2(a)(3) of the Investment Company Act of 1940. "Registered representative" means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 or a person described in section 202(a)(17) of the Investment Advisors Act of 1940.

Effective Date

The provision is effective with respect to investment advice provided on or after January 1, 2003.

E. Employer-Provided Qualified Retirement Planning Services (sec. 107 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.[10] 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.

Explanation of Provision

The provision permits employers to offer employees a choice between cash compensation and eligible qualified retirement planning services. The provision only applies to qualified retirement planning services provided by a qualified investment advisor. It is intended that qualified investment advisors will be certified and regulated under applicable laws and regulations. In addition, qualified investment advisors also include investment advisors within a financial institution's trust or custody department chartered under the National Bank Act.[11] 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

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

[11] 12 U.S.C. 92(a).

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 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, 2002.

F. Effective Date for Collectively Bargained Plans and Plan Amendments (sec. 109 of the bill)

Present Law

Plan amendments to reflect amendments to 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.

Explanation of Provision

Delayed effective date for collectively bargained plans

The provision provides a delayed effective date for collectively bargained plans. Under the provision, in the case of a plan maintained pursuant to one or more collective bargaining agreements ratified on or before the date of enactment, the amendments made by Title I of the bill are applied beginning with the first plan year beginning on or after the earlier of:

(1) The later of: (a) January 1, 2004, or (b) 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) January 1, 2005.

Time for making plan amendments

If the amendments made by the provisions of the bill relating to benefit statements, notices to participants, informational and educational support for plan fiduciaries, or diversification of employer securities require an amendment to the plan, such plan amendment is not required to be made before the first plan year beginning on or after January 1, 2005, if, during the period after the provisions of the proposal take effect and before such first plan year, the plan is operated in accordance with the provisions of the bill and the plan amendment applies retroactively.

Effective Date

The provision is effective on the date of enactment.

TITLE II: OTHER TAX PROVISIONS RELATING TO PENSIONS

A. Amendments to Retirement Protection Act of 1994 (sec. 201 of the bill and sec. 412 of the Code)

Present Law

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

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

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

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

For plan years beginning after 2004 and before 2010, the funded current liability percentage will be deemed to be at least 90 percent if the actual funded current liability percentage is at least at certain specified levels.

The relief from the minimum funding requirements applies for the plan year beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

Explanation of Provision

The provision modifies the special funding rule for plans sponsored by a company engaged primarily in interurban or interstate passenger bus service by making the rule permanent.

In addition, the provision modifies the rule by providing that (1) the funded current liability percentage of a plan to which the rule applies is treated as not less than 90 percent for purposes of the minimum funding rules applicable to underfunded plans, and (2) the funded current liability percentage of a plan to which the rule applies is treated as not less than 100 percent for purposes of the quarterly contribution requirement.

Effective Date

The provision is effective with respect to plan years beginning after December 31, 2001.

B. Pension Plan Reporting Simplification (sec. 202 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.[12] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

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

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

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 plans that satisfy the eligibility requirements for Form 5500-EZ (referred to as 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

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

the Treasury and the Secretary of Labor to provide simplified reporting requirements for plan years beginning after December 31, 2003, for certain plans with fewer than 25 employees.

Effective Date

The provision relating to one-participant plans is effective for plans beginning on or after January 1, 2002. The provision relating to simplified reporting for plans with fewer than 25 employees is effective on the date of enactment.

C. Improvement of Employee Plans Compliance Resolution System (sec. 203 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), or section 403(b), as applicable.[13] 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 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") program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("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.

Explanation of Provision

The Secretary of the Treasury is directed to continue to update and improve EPCRS, 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

[13] Rev. Proc. 2001-17, 2001-7 I.R.B. 589.

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.

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

Effective Date

The provision is effective on the date of enactment.

D. Flexibility in Nondiscrimination, Coverage, and Line of Business Rules (sec. 204 of the bill and secs. 401(a)(4), 410(b) and 414(r) of the Code)

Present Law

A plan is not a qualified retirement plan if the contributions or benefits provided under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The applicable Treasury regulations set forth the exclusive rules for determining whether a plan satisfies the nondiscrimination requirement. These regulations state that the form of the plan and the effect of the plan in operation determine whether the plan is nondiscriminatory and that intent is irrelevant.

Similarly, a plan is not a qualified retirement plan if the plan does not benefit a minimum number of employees (sec. 410(b)). A plan satisfies this minimum coverage requirement if and only if it satisfies one of the tests specified in the applicable Treasury regulations. If an employer is treated as operating separate lines of business, the employer may apply the minimum coverage requirements to a plan separately with respect to the employees in each separate line of business (sec. 414(r)). Under a so-called "gateway" requirement, however, the plan must benefit a classification of employees that does not discriminate in favor of highly compensated employees in order for the employer to apply the minimum coverage requirements separately for the employees in each separate line of business. A plan satisfies this gateway requirement only if it satisfies one of the tests specified in the applicable Treasury regulations.

Explanation of Provision

The Secretary of the Treasury is directed to modify, on or before December 31, 2003, the existing regulations issued under section 414(r) in order to expand (to the extent that the Secretary may determine to be appropriate) the ability of a plan to demonstrate compliance with the line of business requirements based upon the facts and circumstances surrounding the design and operation of the plan, even though the plan is unable to satisfy the mechanical tests currently used to determine compliance.

The Secretary of the Treasury is directed to provide by regulation applicable to years beginning after December 31, 2003, that a plan is deemed to satisfy the nondiscrimination requirements of section 401(a)(4) if the plan satisfied the pre-1994 facts and circumstances test, satisfied the conditions prescribed by the Secretary to appropriately limit the availability of such test, and is submitted to the Secretary for a determination of whether it satisfies such test (to the extent provided by the Secretary).

Similarly, a plan will comply with the minimum coverage requirement of section 410(b) if the plan satisfied the pre-1989 coverage rules, is submitted to the Secretary for a determination of whether it satisfied the pre-1989 coverage rules (to the extent provided by the Secretary), and satisfies conditions prescribed by the Secretary by regulation that appropriately limit the availability of the pre-1989 coverage rules.

Effective Date

The provision relating to the line of business requirements under section 414(r) is effective on the date of enactment. The provision relating to the nondiscrimination requirements under section 401(a)(4) is effective on the date of enactment, except that any condition of availability prescribed by the Secretary will not be effective before the first year beginning not less than 120 days after the date on which such condition is prescribed. The provision relating to the minimum coverage requirements under section 410(b) is effective for years beginning after December 31, 2003, except that any condition of availability prescribed by the Secretary by regulation will not apply before the first year beginning not less than 120 days after the date on which such condition is prescribed.

E. Extension to all Governmental Plans of Moratorium on Application of Certain Nondiscrimination Rules Applicable to State and Local Government Plans (sec. 205 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 rules concerning nondiscrimination (sec. 401(a)(4)) and minimum participation (sec. 401(a)(26)). All other governmental plans are not exempt from the nondiscrimination and minimum participation rules.

Explanation of Provision

The provision exempts all governmental plans (as defined in sec. 414(d)) from the nondiscrimination and minimum participation rules.

Effective Date

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

F. Notice and Consent Period Regarding Distributions (sec. 206 of the bill and sec. 417 of the Code)

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, 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 IRA, and (3) the rules concerning the taxation of a distribution. If the joint and survivor annuity requirements apply to the participant, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

If the participant's vested accrued benefit does not exceed $5,000, the terms of the plan may provide for distribution without the participant's consent. The plan generally is required, however, to provide to the participant a notice that contains a written explanation of (1) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (2) the rules concerning the taxation of a distribution. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

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. In the case of a description of such consequences that is made before the date 90 days after the date on which the Secretary of the Treasury issues a safe harbor description, the plan administrator will be required to make a reasonable attempt to comply with the requirements of the provision.

Effective Date

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

G. Reduced PBGC Premiums for Small and New Plans (secs. 210-211 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 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.

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

A new defined benefit plan is defined as described above under the flat-rate premium provision of the 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 is effective with respect to plans first effective after December 31, 2001. The reduction of the variable-rate premium for small plans is effective with respect to plan years beginning after December 31, 2002.

H. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds (sec. 212 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.

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.

I. Rules for Substantial Owner Benefits in Terminated Plans (sec. 213 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.

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 applies 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, 2002.

J. Studies (sec. 215 of the bill)

Present Law

No provision.

Explanation of Provision

Study on small employer group plans

The provision directs the Secretary of Labor, in consultation with the Secretary of the Treasury, to conduct a study to determine (1) the most appropriate form(s) of pension plans that would be simple to create and easy to maintain by multiple small employers, while providing ready portability of benefits for all participants and beneficiaries, (2) how such arrangements could be established by employer or employee associations, (3) how such arrangements could provide for employees to contribute independent of employer sponsorship, and (4) appropriate methods and strategies for making such pension plan coverage more widely available to American workers.

The Secretary of Labor is required to consider the adequacy and availability of existing pension plans and the extent to which existing models may be modified to be more accessible to both employees and employers. The Secretary of Labor is required to issue a report within 18 months, including recommendations for one or more model plans or arrangements as described above which may serve as the basis for appropriate administrative or legislative action.

Study on effect of legislation

The provision also directs the Secretary of Labor to report to the Committee on Education and the Workforce of the House of Representatives and the Committee on Health, Education, Labor and Pensions of the Senate regarding the effect of the bill and title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("the 2001 Act") on pension coverage, including any change in the extent of pension plan coverage for low and middle-income workers, the levels of pension plan benefits generally, the quality of pension plan coverage generally, workers' access to and participation in pension plans, and retirement security. This report is required to be submitted no later than five years after the date of enactment.

Effective Date

The provision is effective on the date of enactment.

K. Interest Rate Range for Additional Funding Requirements (sec. 216 of the bill and sec. 412(l) of the Code)

Present Law

In general

ERISA and the Code impose both minimum and maximum[14] funding requirements with respect to defined benefit pension plans. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan. The amount of contributions required for a plan year is generally the amount needed to fund benefits earned during that year 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

Additional contributions are required under a special funding rule if a single-employer defined benefit pension plan is underfunded.[15] Under the special rule, a plan is considered underfunded for a plan year if the value of the plan assets is less than 90 percent of the plan's current liability.[16] The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage."

If a plan is underfunded, the amount of additional required contributions is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

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

[15] Plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

[16] Under an alternative test, a plan is not considered underfunded if (1) the value of the plan assets is at least 80 percent of current liability and (2) the value of the plan assets was at least 90 percent of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years.

Required interest rate

In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. The interest rate used to determine a plan's current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.[17] The permissible range is from 90 percent to 105 percent. As a result of debt reduction, the Department of the Treasury does not currently issue 30-year Treasury securities.

Timing of plan contributions

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

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[18]

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. In order to protect employees and their beneficiaries, the Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans. Employers pay premiums to the PBGC for this insurance coverage.

In the case of an underfunded plan, additional PBGC premiums are required based on the amount of unfunded vested benefits. These premiums are referred to as "variable rate premiums." In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

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[17] 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 (section 412(b)(5)(B)(iii)(II)).

[18] No additional quarterly contributions are due once the plan's funded current liability percentage for the plan year reaches 100 percent.

Special interest rate for 2002 and 2003

Section 405 of the Job Creation and Worker Assistance Act of 2002,[19] enacted March 9, 2002, provides a special interest rate rule applicable in determining the amount of additional contributions for plan years beginning after December 31, 2001, and before January 1, 2004 (the "applicable plan years").[20]

The special rule expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements for the applicable plan years. The permissible range is from 90 percent to 120 percent for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

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

Explanation of Provision

Under the provision, the special interest rate rule for 2002 and 2003 applies also in determining the amount of additional contributions for the 2001 plan year that must be contributed to the plan within 8½ months after the end of the plan year (e.g., by September 15, 2002). The provision does not affect quarterly contributions required to be made for the 2001 plan year.[21]

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

[20] Under a related special rule, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the applicable plan year begins.

[21] The provision also makes conforming changes to the special rule for PBGC variable rate premiums so that (1) the special rule applies for purposes of notices and reporting required with respect to underfunded plans and (2) a similar special rule will apply in the case of the issuance of a new mortality table by the Department of Treasury.

Effective Date

The provision is effective as if included in section 405 of the Job Creation and Worker Assistance Act of 2002.

L. Provisions Relating to Plan Amendments (sec. 217 of the bill)

Present Law

Plan amendments to reflect amendments to 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.

Explanation of Provision

The provision permits certain plan amendments made pursuant to the changes made by title II of the bill or by title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001 (or regulations issued thereunder) to be retroactively effective. If the plan amendment meets the requirements of the bill, then the plan will be treated as being operated in accordance with its terms and the amendment will not violate the prohibition of reductions of accrued benefits for purposes of the Internal Revenue Code. 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, 2005 (January 1, 2007, in the case of a governmental plan). If the amendment is required to be made to retain qualified status as a result of the changes in the law (or regulations), the amendment is required to be made retroactively effective as of the date on which the change became effective with respect to the plan and the plan is required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the changes made by the bill or the 2001 Act (or applicable regulations) could be made retroactive 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 the 2001 Act (or applicable regulations) if it has an effective date before the effective date of the provision of the bill or Act (or regulations) to which it related. Similarly, the provision does not provide relief from section 411(d)(6) for periods prior to the effective date of the relevant provision (or regulations) or the plan amendment.

The Secretary is authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It is intended that the Secretary will not permit inappropriate reductions in contributions or benefits that are not directly related to the provisions of the bill or the 2001 Act. For example, it is intended that a plan that incorporates the section 415 limits by reference can be retroactively amended to impose the section 415 limits in effect before the 2001 Act.[22] 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

[22] 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 the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), in the case of a plan that incorporated the section 415 limits by reference on June 7, 2001, the date of enactment of the 2001 Act.

compensation. It is expected that the Secretary will provide that 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 the 2001 Act. 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 the 2001 Act, the plan is not be 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 the 2001 Act.

Effective Date

The provision is effective on the date of enactment.

TITLE III: STOCK OPTIONS

A. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options from Wages (sec. 301 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.[23]

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. Compensation income is also recognized in the case of a qualifying disposition of employee stock purchase plan stock if the option price reflected a discount.[24] Even though compensation income is recognized upon such dispositions, employers are generally not required to withhold income taxes.

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.[25] The applicable Code provisions[26] do not provide a specific exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option, i.e., for the excess of the fair market value of the stock at the time of exercise over the amount paid for the stock by the individual.

In 1971, the Internal Revenue Service issued a revenue ruling addressing the withholding obligations of a company upon the exercise of a qualified stock option (the predecessor to incentive stock options).[27] The ruling concluded that there is no payment of wages for purposes

[23] Sec. 421.

[24] The amount that must be included in income is the lesser of (1) the excess of the fair market value of the stock at the time of disposition over the amount paid for the stock, or (2) the excess of the fair market value of the stock at the time the option was granted over the option price.

[25] Secs. 3101, 3111 and 3301.

[26] Secs. 3121 and 3306.

[27] Rev. Rul. 71-52, 1971-1 C.B. 278.

of FICA, FUTA, or income tax withholding at the time of exercise. There has been uncertainty as to the extent to which a similar result applies on exercise of an incentive stock option or employee stock purchase plan.

In January 2001, the Internal Revenue Service issued notice of its intent to clarify, through future guidance, the application of FICA, FUTA, and Federal income tax withholding to statutory stock options.[28] The notice provided that in the case of a statutory stock option exercised before January 1, 2003, the IRS would not assess FICA or FUTA taxes upon the exercise of the option and would not treat the disposition of stock acquired pursuant to the exercise of a statutory stock option as subject to Federal income tax withholding. The notice also provided that the Internal Revenue Service would honor claims for refunds of FICA and FUTA taxes paid. The notice also concluded that Revenue Ruling 71-52 is obsolete and that its holding does not apply to the exercise of statutory stock options.

Proposed Treasury regulations issued in November 2001 provide that the payment of FICA and FUTA taxes upon the exercise of statutory stock options will apply to the exercise of statutory stock options on or after January 1, 2003. Federal income tax withholding is not required under the proposed regulations. Consistent with Notice 2001-14, the Internal Revenue Service will not assess FICA or FUTA taxes upon the exercise of a statutory stock option before 2003.

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 exercise of a statutory stock option.[29] 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 applies to stock acquired pursuant to statutory stock options exercised after the date of enactment. It is expected that Treasury and the Internal Revenue Service will not attempt to collect FICA or FUTA taxes attributable to exercises of statutory stock options before the effective date.

[28] Notice 2001-14, 2001-6 I.R.B. 516.

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

TITLE IV: SOCIAL SECURITY HELD HARMLESS

A. No Impact on Social Security and Medicare Trust Funds (sec. 401 of the bill)

Present Law

Present law provides for the transfer of employment taxes and self-employment taxes to the Social Security and Medicare trust funds. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security and Medicare trust funds.

Explanation of Provision

Under the bill, the amounts transferred to the Social Security and Medicare trust funds are determined as if the bill is not enacted. Thus, there will be no reduction in transfers to these funds as a result of the bill.

Effective Date

The provision is effective on the date of enactment.