

**DESCRIPTION OF CHAIRMAN'S MARK OF THE  
"RESTORING EARNINGS TO LIFT INDIVIDUALS AND  
EMPOWER FAMILIES ACT OF 2001"**

Scheduled for Markup  
By the  
SENATE COMMITTEE ON FINANCE  
on May 15, 2001

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## INTRODUCTION

The Senate Committee on Finance has scheduled a markup on May 15, 2001, on a proposed Chairman's mark of the "Restoring Earnings to Lift Individuals and Empower Families Act of 2001". This document,<sup>1</sup> prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's mark.

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<sup>1</sup> This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Mark of the "Restoring Earnings to Lift Individuals and Empower Families Act of 2001"* (JCX-40-01), May 11, 2001.

## **I. MARGINAL TAX RATE REDUCTION PROPOSALS**

### **A. Individual Income Tax Rate Structure**

#### **Present Law**

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

#### **Regular income tax liability**

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2001, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

**Table 1.--Individual Regular Income Tax Rates for 2001**

<b>If taxable income is over:</b>	<b>But not over:</b>	<b>Then regular income tax equals:</b>
<i>Single individuals</i>		
\$0.....	\$27,050	15 percent of taxable income
\$27,050.....	\$65,550	\$4,057.50, plus 28% of the amount over \$27,050
\$65,550.....	\$136,750	\$14,837.50, plus 31% of the amount over \$65,550
\$136,750.....	\$297,350	\$36,909.50, plus 36% of the amount over \$136,750
Over \$297,350.....		\$94,725.50, plus 39.6% of the amount over \$297,350
<i>Heads of households</i>		
\$0.....	\$36,250	15 percent of taxable income
\$36,250.....	\$93,650	\$5,437.50, plus 28% of the amount over \$36,250
\$93,650.....	\$151,650	\$21,509.50, plus 31% of the amount over \$93,650
\$151,650.....	\$297,350	\$39,489.50, plus 36% of the amount over \$151,650
Over \$297,350.....		\$91,941.50, plus 39.6% of the amount over \$297,350
<i>Married individuals filing joint returns</i>		
\$0.....	\$45,200	15 percent of taxable income
\$45,200.....	\$109,250	\$6,780.00, plus 28% of the amount over \$45,200
\$109,250.....	\$166,500	\$24,714.50, plus 31% of the amount over \$109,250
\$166,500.....	\$297,350	\$42,461.50, plus 36% of the amount over \$166,500
Over \$297,350.....		\$89,567.50, plus 39.6% of the amount over \$297,350

**Description of Proposal**

**In general**

The proposal would create a new 10-percent regular income tax bracket for a portion of taxable income that is currently taxed at 15 percent, effective for taxable years beginning after December 31, 2000. The proposal also would reduce other regular income tax rates. By 2007, the present-law individual income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent would be lowered to 25 percent, 28 percent, 33 percent, and 36 percent, respectively.

**New low-rate bracket**

The proposal would establish a new 10-percent regular income tax rate bracket for a portion of taxable income that is currently taxed at 15 percent, as shown in Table 3, below. The

taxable income levels for the new 10-percent rate bracket would be adjusted annually for inflation for taxable years beginning after December 31, 2006.

The 10-percent rate bracket would apply to the first \$6,000 of taxable income for single individuals, \$10,000 of taxable income for heads of households, and \$12,000 for married couples filing joint returns.

**Modification of 15-percent bracket**

The 15-percent regular income tax bracket would be modified to begin at the end of the new low-rate regular income tax bracket. The 15-percent regular income tax bracket would end at the same level as under present law.

**Reduction of other rates**

The present-law regular income tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent would be phased-down over six years to 25 percent, 28 percent, 33 percent, and 36 percent, effective for taxable years beginning after December 31, 2001. The taxable income levels for the new rates would be the same as the taxable income levels that apply under the present-law rates.

Table 2, below, shows the schedule of proposed regular income tax rate reductions.

**Table 2.--Proposed Regular Income Tax Rate Reductions**

<b>Calendar year</b>	<b>28% rate reduced to:</b>	<b>31% rate reduced to:</b>	<b>36% rate reduced to:</b>	<b>39.6% rate reduced to:</b>
2002-2004	27%	30%	35%	38.6%
2005-2006	26%	29%	34%	37.6%
2007 and later	25%	28%	33%	36%

**Projected regular income tax rate schedules under the proposal**

Table 3, below, shows the projected individual regular income tax rate schedules when the rate reductions are fully phased-in (i.e., for 2007). As under present law, the rate brackets for married taxpayers filing separate returns would be one half the rate brackets for married individuals filing joint returns. In addition, appropriate adjustments would be made to the separate, compressed rate schedule for estate and trusts.

**Table 3.--Individual Regular Income Tax Rates for 2007 (Projected)**

<b>If taxable income is:</b>	<b>But not over:</b>	<b>Then regular income tax equals:</b>
<i>Single individuals</i>		
\$0.....	\$6,150	10 percent of taxable income
\$6,150.....	\$31,700	\$615, plus 15 percent of the amount over \$6,150
\$31,700.....	\$76,800	\$4,447.50, plus 25% of the amount over \$31,700
\$76,800.....	\$160,250	\$15,722.50 plus 28% of the amount over \$76,800
\$160,250.....	\$348,350	\$39,088.50 plus 33% of the amount over \$160,250
Over \$348,350.....		\$101,161.50, plus 36% of the amount over \$348,350
<i>Heads of households</i>		
\$0.....	\$10,250	10 percent of taxable income
\$10,250.....	\$42,500	\$1,025, plus 15% of the amount over \$10,250
\$42,500.....	\$109,700	\$5,862.50, plus 25% of the amount over \$42,500
\$109,700.....	\$177,650	\$22,662.50, plus 28% of the amount over \$109,700
\$177,650.....	\$348,350	\$41,688.50, plus 33% of the amount over \$177,650
Over \$348,350.....		\$98,019.50, plus 36% of the amount over \$348,350
<i>Married individuals filing joint returns</i>		
\$0.....	\$12,300	10 percent of taxable income
\$12,300.....	\$57,130 <sup>2</sup>	\$1,230, plus 15% of the amount over \$12,300
\$57,130.....	\$128,000	\$7,954.50, plus 25% of the amount over \$57,130
\$128,000.....	\$195,050	\$25,672, plus 28% of the amount over \$128,000
\$195,050.....	\$348,350	\$44,446, plus 33% of the amount over \$195,050
Over \$348,350.....		\$95,035, plus 36% of the amount over \$348,350

**Revised wage withholding for 2001**

Under present law, the Secretary of the Treasury is authorized to prescribe appropriate income tax withholding tables or computational procedures for the withholding of income taxes from wages paid by employers. The Secretary would be expected to make appropriate revisions to the wage withholding tables to reflect the proposed rate reduction for calendar year 2001 as expeditiously as possible.

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<sup>2</sup> The end point of the 15-percent rate bracket for married individuals filing joint returns also reflects the phase-in of the increase in the size of the 15-percent bracket proposed in Part III.B., below.

### **Effective Date**

The new 10-percent rate bracket would be effective for taxable years beginning after December 31, 2000. The reduction in the 28 percent, 31 percent, 36 percent, and 39.6 percent rates would be phased-in beginning in taxable years beginning after December 31, 2001.

## **B. Increase Starting Point for Phase-Out of Itemized Deductions**

### **Present Law**

#### **Itemized deductions**

Taxpayers may choose to claim either the basic standard deduction (and additional standard deductions, if applicable) or itemized deductions (subject to certain limitations) for certain expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

#### **General limitation on itemized deductions ("Pease" limitation)**

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of \$132,950 in 2001 (\$66,475 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present-law limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under this provision, the otherwise allowable itemized deductions may not be reduced by more than 80 percent.

### **Description of Proposal**

The proposal would increase the starting point of the overall limitation on itemized deductions for all taxpayers (other than married couples filing separate returns) to the starting point of the personal exemption phase-out for married couples filing a joint return. This amount is projected under present law to be \$245,500 in 2009. The starting point of the overall limitation on itemized deductions for married couples filing separate returns would continue to be one-half of the amount for other taxpayers.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2008.

## **C. Repeal of Phase-Out of Personal Exemption**

### **Present Law**

In order to determine taxable income, an individual reduces adjusted gross income by any personal exemptions, deductions, and either the applicable standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2001, the amount deductible for each personal exemption is \$2,900. This amount is adjusted annually for inflation.

Under present law, the deduction for personal exemptions is phased-out ratably for taxpayers with adjusted gross income over certain thresholds. The applicable thresholds for 2001 are \$132,950 for single individuals, \$199,450 for married individuals filing a joint return, \$166,200 for heads of households, and \$99,725 for married individuals filing separate returns. These thresholds are adjusted annually for inflation.

The total amount of exemptions that may be claimed by a taxpayer is reduced by 2 percent for each \$2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold. The phase-out rate is 2 percent for each \$1,250 for married taxpayers filing separate returns. Thus, the personal exemptions claimed are phased-out over a \$122,500 range (\$61,250 for married taxpayers filing separate returns), beginning at the applicable threshold. The size of these phase-out ranges (\$122,500/\$61,250) is not adjusted for inflation. For 2001, the point at which a taxpayer's personal exemptions are completely phased-out is \$255,450 for single individuals, \$321,950 for married individuals filing a joint return, \$288,700 for heads of households, and \$160,975 for married individuals filing separate returns.

### **Description of Proposal**

The proposal would repeal the personal exemption phase-out.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2008.

## **II. INCREASE AND EXPAND THE CHILD TAX CREDIT**

### **Present Law**

Under present law, an individual may claim a \$500 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by \$50 for each \$1,000 (or fraction thereof) of modified adjusted gross income over \$75,000 for single individuals or heads of households, \$110,000 for married individuals filing joint returns, and \$55,000 for married individuals filing separate returns. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (sec. 931); and residents of Puerto Rico (sec. 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between \$75,000 and \$85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between \$75,000 and \$95,000.

The child tax credit is not adjusted annually for inflation.

In general, the child tax credit is nonrefundable. However, for families with three or more qualifying children, the child tax credit is refundable up to the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit.

### **Alternative minimum tax liability**

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit and, for taxable years beginning after December 31, 2001, the amount of the refundable child credit for families with three or more children. This is known as the alternative minimum tax offset of refundable credits.

Through 2001, an individual generally may reduce his or her tentative alternative minimum tax liability by nonrefundable personal tax credits (such as the \$500 child tax credit and the adoption tax credit). For taxable years beginning after December 31, 2001, nonrefundable personal tax credits may not reduce an individual's income tax liability below his or her tentative alternative minimum tax.

### **Description of Proposal**

The proposal would increase the child tax credit to \$1,000, phased-in over eleven years, effective for taxable years beginning after December 31, 2000. The proposal would allow the child credit to be claimed against the alternative minimum tax permanently and would repeal the alternative minimum tax offset of refundable credits.

Table 4, below, shows the proposed increase of the child tax credit.

**Table 4.--Proposed Increase of the Child Tax Credit**

<b>Calendar Year</b>	<b>Credit Amount Per Child</b>
2001-2003	\$600
2004-2006	\$700
2007-2009	\$800
2010	\$900
2011 and later	\$1,000

The proposal would make the child credit refundable to the extent of 15 percent of the taxpayer's earned income in excess of \$10,000. Thus, in 2001, families with earned income of at least \$14,000 and one child will get a refundable credit of \$600. Families with three or more children would be permitted to use the present-law refundable child credit or the proposed refundable child credit.

**Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2000.

### **III. MARRIAGE PENALTY RELIEF PROVISIONS**

#### **A. Standard Deduction Marriage Penalty Relief**

##### **Present Law**

##### **Marriage penalty**

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

##### **Basic standard deduction**

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),<sup>3</sup> which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

##### **Description of Proposal**

The proposal would increase the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately would continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately would be the same. The increase would be phased-in over five years beginning in 2006 and would be fully phased-in for 2010 and thereafter. Table 5, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

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<sup>3</sup> Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

**Table 5.--Phase-In of Increase of Standard Deduction  
for Married Couples Filing Joint Returns**

<b>Calendar Year</b>	<b>Standard Deduction for Joint Returns as Percentage of Standard Deduction for Single Returns</b>
2006	174%
2007	180%
2008	187%
2009	193%
2010 and later	200%

**Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2005.

## **B. Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns**

### **Present Law**

#### **In general**

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

#### **Regular income tax liability**

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.<sup>4</sup> The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

### **Description of Proposal**

The proposal would increase the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase would be phased-in over five years, beginning in 2006. Therefore, this provision would be fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2009. Table 6, below, shows the proposed increase in the size of the 15-percent bracket during the phase-in period.

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<sup>4</sup> The rate bracket breakpoint for the 39.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

**Table 6.--Increase in Size of 15-Percent Rate Bracket  
for Married Couples Filing a Joint Return**

<b><u>Taxable year</u></b>	<b><u>End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals</u></b>
2006	174%
2007	180%
2008	187%
2009	193%
2010 and thereafter	200%

**Effective Date**

The increase in the size of the 15-percent rate bracket would be effective for taxable years beginning after December 31, 2005.

## **C. Marriage Penalty Relief and Simplification Relating to the Earned Income Credit**

### **Present Law**

#### **In general**

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children. The earned income credit is not available to married individuals who file separate returns.

#### **Definition of qualifying child and tie-breaker rules**

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son or daughter or a descendant of either;<sup>5</sup> (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child is an individual (1) who is a brother, sister, stepbrother or stepsister of the taxpayer (or a descendant of any such relative) or who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.<sup>6</sup>

If a child otherwise qualifies with respect to more than one person, the child is treated as a qualifying child only of the person with the higher modified adjusted gross income.

#### **Definition of earned income**

To claim the earned income credit, the taxpayer must have earned income. Earned income consists of wages, salaries, other employee compensation, and net earnings from self employment. Employee compensation includes anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income include the following: (1) elective

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<sup>5</sup> A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

<sup>6</sup> Sec. 32(c)(3)(B)(ii).

deferrals under a cash or deferred arrangement or section 403(b) annuity (sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (sec. 106), dependent care (sec. 129), adoption assistance (sec. 137), educational assistance (sec. 127), and miscellaneous fringe benefits (sec. 132); (3) salary reduction contributions under a cafeteria plan (sec. 125); (4) meals and lodging provided for the convenience of the employer (sec. 119), and (5) housing allowance or rental value of a parsonage for the clergy (sec. 107). Some of these items are not required to be reported on the Wage and Tax Statement (Form W-2).

### **Calculation of the credit**

The maximum earned income credit is phased-in as an individual's earned income increases. The credit phases-out for individuals with earned income (or if greater, modified adjusted gross income<sup>7</sup>) over certain levels. In the case of a married individual who files a joint return, the earned income credit both for the phase-in and phase-out is calculated based on the couples' combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) modified adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

For taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or modified adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount is reduced, falling to \$0 at the "breakeven" income level, the point where a specified percentage of "excess" income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are adjusted annually for inflation. Table 7, below, shows the earned income credit parameters for taxable year 2001.<sup>8</sup>

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<sup>7</sup> "Modified adjusted gross income" means adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income. The losses disregarded are: (1) net capital losses (up to \$3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. For purposes of (4), amounts attributable to a business that consists of the performance of services by the taxpayer as an employee are not taken into account. The amounts added to AGI to arrive at modified AGI include: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers). Sec. 32(c)(5).

<sup>8</sup> The table is based on Rev. Proc. 2001-13.

**Table 7.--Earned Income Credit Parameters (2001)**

	<b>Two or more qualifying children</b>	<b>One qualifying child</b>	<b>No qualifying children</b>
Credit rate (percent) .....	40.00%	34.00%	7.65%
Earned income amount.....	\$10,020	\$7,140	\$4,760
Maximum credit.....	\$4,008	\$2,428	\$364
Phase-out begins .....	\$13,090	\$13,090	\$5,950
Phase-out rate (percent).....	21.06%	15.98%	7.65%
Phase-out ends.....	\$32,121	\$28,281	\$10,710

No earned income credit is allowed if the taxpayer has disqualified income in excess of \$2,450 (for 2001) for the taxable year. Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income for the taxpayer year; and (5) net passive income for the taxable year.

**Description of Proposal**

For married taxpayers who file a joint return, the proposal would increase the beginning and ending of the earned income credit phase-out by \$3,000. These beginning and ending points would be adjusted annually for inflation after 2002.

The proposal would simplify the definition of earned income by excluding nontaxable earned income amounts from the definition of earned income for EIC purposes. Thus, under the proposal, earned income would include wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self employment.

The proposal would repeal the present-law provision that reduces the earned income credit by the amount of an individual's alternative minimum tax.

The proposal would simplify the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

The proposal would provide that the relationship test is met if the individual is the taxpayer's son, daughter, stepdaughter, brother, sister, stepbrother, stepsister, or a descendant of any such individuals.<sup>9</sup> A foster child would also satisfy the relationship test. A foster child would be defined as an individual who is placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child. In order to be a qualifying child,

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<sup>9</sup> As under present law, an adopted child would be treated as a child of the taxpayer by blood.

the individual must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

The proposal would eliminate the present-law tie-breaking rule. Under the proposal, if an individual would be a qualifying child with respect to more than one taxpayer and more than one taxpayer claims the earned income credit, then the following tie-breaking rules would apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child would be considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return, then the child would be considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year and second of the parent with the highest adjusted gross income. Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child would be considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

The proposal would authorize the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed. The proposal would provide that, by September 2002, the Department of the Treasury is to deliver to the Senate Committee on Finance and the House Committee on Ways and Means a study of the Federal Case Registry database. The Department of the Treasury would study (1) the accuracy and timeliness of the data in the Federal Case Registry, (2) the efficacy of using math error authority in this instance in reducing costs due to erroneous and fraudulent claims, and (3) the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data.

#### **Effective Date**

The proposal generally would be effective for taxable years beginning after December 31, 2001. The proposal to authorize the IRS to use math error authority if the Federal Case Registry indicates the taxpayer is the noncustodial parent would be effective beginning in 2004.

## IV. EDUCATION INCENTIVES

### A. Modifications to Education IRAs

#### Present Law

##### In general

Section 530 of the Internal Revenue Code (the “Code”) provides tax-exempt status to education individual retirement accounts (“education IRAs”), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash.<sup>10</sup> Annual contributions to education IRAs may not exceed \$500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18.

##### Phase-out of contribution limit

The \$500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified adjusted gross income (“AGI”) between \$95,000 and \$110,000. The phase-out range for married taxpayers filing a joint return is \$150,000 to \$160,000 of modified AGI. Individuals with modified AGI above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

##### Treatment of distributions

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the total distribution does not exceed the “qualified higher education expenses” incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary’s gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary.

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<sup>10</sup> Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

The additional 10-percent tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

### **Qualified higher education expenses**

The term “qualified higher education expenses” includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, \$1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution’s “normal” room and board charge; and (3) for all other students, \$2,500 per academic year.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee’s gross income under section 127.

Present law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

### **Time for making contributions**

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.

### **Coordination with HOPE and Lifetime Learning credits**

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

### **Coordination with qualified tuition programs**

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6 percent of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

## **Description of Proposal**

### **Redesignation of education IRAs as Coverdell education savings accounts**

The proposal would rename “education IRAs” as “Coverdell education savings accounts.”

### **Annual contribution limit**

The proposal would increase the annual limit on contributions to Coverdell education savings accounts from \$500 to \$2,000. Thus, aggregate contributions that could be made by all contributors to one (or more) Coverdell education savings account established on behalf of any particular beneficiary would be limited to \$2,000 for each year.

### **Qualified education expenses**

The proposal would expand the definition of qualified education expenses that may be paid tax-free from a Coverdell education savings account to include “qualified elementary and secondary school expenses,” meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, computer equipment (including related software and services), and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law, and (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary.

### **Phase-out of contribution limit**

The proposal would increase the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return would be \$190,000 to \$220,000 of modified AGI.

### **Special needs beneficiaries**

The proposal would provide that the rule prohibiting contributions to a Coverdell education savings account after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in a Coverdell education savings account would not occur when a special needs beneficiary reaches age 30.

### **Contributions by persons other than individuals**

The proposal would clarify that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to Coverdell education savings accounts, regardless of the income of the corporation or entity during the year of the contribution.

### **Contributions permitted until April 15**

Under the proposal, individual contributors to Coverdell education savings accounts would be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual’s Federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally could make contributions for a year until April 15 of the following year.

### **Qualified room and board expenses**

The proposal would modify the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, below.

### **Coordination with HOPE and Lifetime Learning credits**

The proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from a Coverdell education savings account on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

### **Coordination with qualified tuition programs**

The proposal would repeal the excise tax on contributions made by any person to a Coverdell education savings account on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

If distributions from a Coverdell education savings account and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary would be required to allocate the expenses between the distributions to determine the amount includible in income.

### **Effective Date**

The provisions modifying Coverdell education savings accounts would be effective for taxable years beginning after December 31, 2001, except that the redesignation of education IRAs as Coverdell education savings accounts would be effective on the date of enactment.

## **B. Private Prepaid Tuition Programs; Exclusion From Gross Income of Education Distributions From Qualified Tuition Programs**

### **Present Law**

Section 529 of the Code provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution,<sup>11</sup> as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.<sup>12</sup>

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.<sup>13</sup> Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is

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<sup>11</sup> An "eligible education institution" is defined the same for purposes of education IRAs (described above) and qualified State tuition programs.

<sup>12</sup> Distributions from qualified State tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

<sup>13</sup> Special estate and gift tax rules apply to contributions made to and distributions made from qualified State tuition programs.

a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)-(9).

Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

## **Description of Proposal**

### **Qualified tuition program**

The proposal would expand the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons would be able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in section 529(b)(1)(A)(ii)). Except to the extent provided in regulations a tuition program maintained by a private institution would not be treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

### **Exclusion from gross income**

Under the proposal, an exclusion from gross income would be provided for distributions made in taxable years beginning after December 31, 2001, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income would be extended to distributions from qualified tuition programs established and maintained by an entity other than a State (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

### **Qualified higher education expenses**

The proposal would provide that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board.<sup>14</sup>

### **Coordination with HOPE and Lifetime Learning credits**

The proposal would allow a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

### **Rollovers for benefit of same beneficiary**

The proposal would provide that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment would apply to a maximum of three such transfers with respect to the same designated beneficiary.

### **Member of family**

The proposal would provide that, for purposes of tax-free rollovers and changes of designated beneficiaries, a “member of the family” includes first cousins of the original beneficiary.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a State (or agency or instrumentality thereof) would be effective for taxable years beginning after December 31, 2003.

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<sup>14</sup> This definition would also apply to distributions from education IRAs.

## C. Exclusion for Employer-Provided Educational Assistance

### Present Law

Educational expenses paid by an employer for its employees are generally deductible by the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of \$5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses beginning after June 30, 1996. The exclusion for employer-provided educational assistance for undergraduate courses expires with respect to courses beginning after December 31, 2001.

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).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.<sup>15</sup> In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 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. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.<sup>16</sup>

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<sup>15</sup> These rules also apply in the event that section 127 expires.

<sup>16</sup> In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous expenses, exceed two percent of the taxpayer's AGI. An individual's total deductions may also be reduced by the overall limitation on itemized deductions under section 68. These limitations do not apply in determining whether an item is excludable from income as a working condition fringe benefit.

### **Description of Proposal**

The proposal would extend the exclusion for employer-provided educational assistance to graduate education and make the exclusion (as applied to both undergraduate and graduate education) permanent.

### **Effective Date**

The proposal would be effective with respect to courses beginning after December 31, 2001.

## **D. Modifications to Student Loan Interest Deduction**

### **Present Law**

Certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable annual deduction is \$2,500. The deduction is phased-out ratably for single taxpayers with modified AGI between \$40,000 and \$55,000 and for married taxpayers filing joint returns with modified AGI between \$60,000 and \$75,000. The income ranges will be adjusted for inflation after 2002.

### **Description of Proposal**

The proposal would increase the income phase-out ranges for eligibility for the student loan interest deduction to \$50,000 to \$65,000 for single taxpayers and to \$100,000 to \$130,000 for married taxpayers filing joint returns. These income phase-out ranges would be adjusted annually for inflation after 2002.

The proposal would repeal both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

### **Effective Date**

The proposal would be effective for interest paid on qualified education loans after December 31, 2001.

**E. Eliminate Tax on Awards Under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program**

**Present Law**

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section 117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the “NHSC Scholarship Program”) and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the “Armed Forces Scholarship Program”) provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

**Description of Proposal**

The proposal would provide that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment would not apply to amounts received by students for regular living expenses, including room and board.

**Effective Date**

The proposal would be effective for education awards received after December 31, 2001.

## **F. Tax Benefits for Certain Types of Bonds for Educational Facilities and Activities**

### **Present Law**

#### **Tax-exempt bonds**

##### **In general**

Interest on debt<sup>17</sup> incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (Code sec. 103).<sup>18</sup> Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person generally is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called “private activity bonds.”<sup>19</sup> The term “private person” includes the Federal Government and all other individuals and entities other than States or local governments.

##### **Private activities eligible for financing with tax-exempt private activity bonds**

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code -- including elementary, secondary, and post-secondary schools -- may be financed with tax-exempt private activity bonds (“qualified 501(c)(3) bonds”).

States or local governments may issue tax-exempt “exempt-facility bonds” to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for “environmental enhancements of hydro-electric generating facilities.” Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time

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<sup>17</sup> Hereinafter referred to as “State or local government bonds.”

<sup>18</sup> Interest on this debt is included in calculating the “adjusted current earnings” preference of the corporate alternative minimum tax.

<sup>19</sup> Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified redevelopment bonds"), and eligible empowerment zone and enterprise community businesses.

Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Private activity tax-exempt bonds may not be issued to finance schools for private, for-profit businesses.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to \$62.50 per resident of the State, or \$187.5 million if greater. The volume limits are scheduled to increase to the greater of \$75 per resident of the State or \$225 million in calendar year 2002. After 2002, the volume limits will be adjusted annually for inflation.

#### Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Present law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.<sup>20</sup> Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.<sup>21</sup> Issuers qualifying for this

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<sup>20</sup> In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

<sup>21</sup> Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

“construction bond” exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by “small” governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more than \$5 million of tax-exempt governmental bonds in a calendar year. The \$5 million limit is increased to \$10 million if at least \$5 million of the bonds are used to finance public schools.<sup>22</sup>

### **Qualified zone academy bonds**

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue “qualified zone academy bonds.” Under present law, a total of \$400 million of qualified zone academy bonds may be issued in each of 1998 through 2001. The \$400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

“Qualified zone academy bonds” are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a “qualified zone academy” and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

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<sup>22</sup> The Small Business Job Protection Act of 1996 permitted issuance of the additional \$5 million in public school bonds by small governments. Previously, small governments were defined as governments that issued no more than \$5 million of governmental bonds without regard to the purpose of the financing.

A school is a “qualified zone academy” if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enterprise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

### **Description of Proposal**

#### **Increase amount of governmental bonds that may be issued by governments qualifying for the “small governmental unit” arbitrage rebate exception**

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirement would be increased from \$5 million to \$10 million. Thus, these governmental units could issue up to \$15 million of governmental bonds in a calendar year provided that at least \$10 million of the bonds were used for public schools.

#### **Allow issuance of tax-exempt bonds for privately owned public school facilities**

The private activities for which tax-exempt bonds may be issued would be expanded to include elementary and secondary public school facilities that are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The term school facility would include school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events) and depreciable personal property used in the school facility. The school facilities for which these bonds are issued would be required to be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement would be defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes, or equips a school facility for a public school agency (typically pursuant to a lease arrangement). The agreement would be required to provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds would be subject to annual per-State volume limits equal to the greater of \$10 per resident or \$5 million in lieu of the present-law State private activity bond volume limits. As with the present-law State private activity bond volume limits, State would be permitted to decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises could be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

### **Effective Date**

The proposals would be effective for bonds issued after December 31, 2001.

## **G. Deduction for Qualified Higher Education Expenses**

### **Present Law**

#### **Deduction for education expenses**

Under present law, an individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under Internal Revenue Code ("the Code") section 162 if the education or training (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, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162-5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income ("AGI").

#### **HOPE and Lifetime Learning credits**

##### **HOPE credit**

Under present law, individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes of up to \$1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first \$1,000 of qualified tuition and related expenses, and 50 percent on the next \$1,000 of qualified tuition and related expenses.<sup>23</sup> The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.<sup>24</sup> The HOPE credit that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns). For taxable years beginning after 2001, the \$1,500 maximum HOPE credit amount and the AGI phase-out ranges are indexed for inflation.

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<sup>23</sup> Thus, an eligible student who incurs \$1,000 of qualified tuition and related expenses is eligible (subject to the AGI phase-out) for a \$1,000 HOPE credit. If an eligible student incurs \$2,000 of qualified tuition and related expenses, then he or she is eligible for a \$1,500 HOPE credit.

<sup>24</sup> The HOPE credit may not be claimed against a taxpayer's alternative minimum tax liability.

The HOPE credit is available for “qualified tuition and related expenses,” which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year.

#### Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to \$5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is \$1,000). For expenses paid after December 31, 2002, up to \$10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be \$2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family -- that is, the HOPE credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between \$40,000 and \$50,000 (\$80,000 and \$100,000 for joint returns).

#### Description of Proposal

The proposal would permit taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses would be defined in the same manner as for purposes of the HOPE credit under present law.

In 2002 and 2003, taxpayers with adjusted gross income that does not exceed \$65,000 (\$130,000 in the case of married couples filing joint returns) would be entitled to a maximum deduction of \$3,000 per year. Taxpayers with adjusted gross income above these thresholds

would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed \$65,000 (\$130,000 in the case of married taxpayers filing joint returns) would be entitled to a maximum deduction of \$5,000 and taxpayers with adjusted gross income that does not exceed \$80,000 (\$160,000 in the case of married taxpayers filing joint returns) would be entitled to a maximum deduction of \$2,000.

Taxpayers would not be eligible to claim the HOPE credit and the deduction in the same taxable year.

#### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001, and before January 1, 2006.

## V. ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

### A. Phase-Out and Repeal of Estate and Generation-Skipping Transfer Taxes; Increase in Gift Tax Unified Credit Effective Exemption

#### Present Law

##### Estate and gift tax rules

###### In general

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first \$10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over \$3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between \$10 million and \$17,184,000, which has the effect of phasing out the benefit of the graduated rates. Thus, these estates are subject to a top marginal rate of 60 percent. Estates over \$17,184,000 are subject to a flat rate of 55 percent, as the benefit of the graduated rates has been phased-out.

###### Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of \$10,000 (adjusted for inflation occurring after 1997) of transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is \$20,000. Unlimited transfers between spouses are permitted without imposition of a gift tax.

###### Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax transfers totaling \$675,000 in 2001, \$700,000 in 2002 and 2003, \$850,000 in 2004, \$950,000 in 2005, and \$1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applies between the 18-percent and 37-percent estate and gift tax rates. Thus, in 2001, taxable transfers, after application of the unified credit, are effectively subject to estate and gift tax rates beginning at 37 percent.

###### Transfers to a surviving spouse

A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a “qualified terminable interest” also are eligible for the marital deduction. A “qualified terminable interest” is property: (1) which passes from the decedent, (2) in which the surviving spouse has a “qualifying income interest for life,” and (3) to which an election under these rules applies. A “qualifying income interest for life” exists if: (1) the surviving spouse is entitled to all the income from the property (payable

annually or at more frequent intervals) or the right to use property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

#### Expenses, indebtedness, and taxes

An estate tax deduction is allowed for funeral expenses and administration expenses of an estate. An estate tax deduction also is allowed for claims against the estate and unpaid mortgages on, or any indebtedness in respect of, property for which the value of the decedent's interest therein, undiminished by the debt, is included in the value of the gross estate.

If the total amount of claims and debts against the estate exceeds the value of the property to which the claims relate, an estate tax deduction for the excess is allowed, provided such excess is paid before the due date of the estate tax return. A deduction for claims against the estate generally is permitted only if allowable by the law of the jurisdiction under which the estate is being administered.

A deduction also is allowed for the full unpaid amount of any mortgage upon, or of any other indebtedness in respect of, any property of the gross estate (including interest which has accrued thereon to the date of the decedent's death), provided that the full value of the underlying property is included in the decedent's gross estate.

#### Basis of property received

In general.--A taxpayer who receives property from a decedent's estate or from a donor of a lifetime gift may want to sell or otherwise dispose of the property. Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer's basis in such property.

Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor plus any gift tax paid on any unrealized appreciation. The basis of a lifetime gift, however, generally may not exceed the property's fair market value on the date of the gift.

Property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of any income on the appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss.

Special rules for interests in certain foreign entities.--Stepped-up basis treatment generally is denied to certain interests in foreign entities. Under present law, stock or securities in a foreign personal holding company takes a carryover basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of accumulated earnings and profits. In addition, stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

#### Provisions affecting small and family-owned businesses and farms

Special-use valuation.--An executor may elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is \$750,000 (adjusted for inflation occurring after 1997). Real property generally may qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction.--An estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to \$675,000.<sup>25</sup> A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or

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<sup>25</sup> The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of \$675,000 is elected, then the unified credit effective exemption amount is \$625,000, for a total of \$1.3 million. If the qualified family-owned business deduction is less than \$675,000, then the unified credit effective exemption amount is equal to \$625,000, increased by the difference between \$675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above the generally applicable exemption amount in effect for the taxable year.

business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100 percent of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: the disqualifying event occurs during the seventh year after the decedent's death, 80 percent; the disqualifying event occurs during the eighth year after the decedent's death, 60 percent; the disqualifying event occurs during the ninth year after the decedent's death, 40 percent; and the disqualifying event occurs during the tenth year after the decedent's death, 20 percent. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period may be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

An estate may claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50 percent of the decedent's gross estate, if the estate claimed special-use valuation, then the property's special-use value is used.

#### State death tax credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any state or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "soak-up" estate tax, which applies when the State death tax liability is less than the maximum Federal death tax credit. In such a case, a tax is imposed by the State, which is equal to the difference between the State death tax

liability and the maximum State death tax credit. This provides States with the maximum amount of death tax for which the State death tax credit provides.

#### Estate and gift taxation of nonresident noncitizens

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Estates of nonresident noncitizens generally are taxed at same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes.

Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of \$13,000, which effectively exempts \$60,000 in assets from estate tax.

#### Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a “skip person” (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. The generation-skipping transfer tax is imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of \$1 million (adjusted for inflation occurring after 1997).

#### Selected income tax provisions

##### Transfers to certain foreign trusts and estates

Transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

##### Net operating loss and capital loss carryovers

Under present law, a capital loss and net operating loss from business operations sustained by a decedent during his last taxable year are deductible only on the final return filed in his or her behalf. Such losses are not deductible by his or her estate.

### Transfers of property in satisfaction of a pecuniary bequest

Under present law, gain or loss is recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of the property at the time of the transfer exceeds the basis of the property, which generally is the basis stepped up to fair market value on the date of the decedent's death.

### Income tax exclusion for the gain on the sale of a principal residence

A taxpayer generally may exclude up to \$250,000 (\$500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years.

To be eligible, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the \$250,000 (\$500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

### Excise tax on nonexempt trusts

Under present law, a split-interest trust may be subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A split-interest trust subject to these rules would be prohibited from engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with the restrictions would subject the split-interest trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

## Description of Proposal

### Overview of proposal

Beginning in 2011, the estate and generation-skipping transfer taxes would be repealed. After repeal, the basis of assets received from a decedent generally would equal the basis of the decedent (i.e., carryover basis) at death. However, a decedent's estate would be permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The basis of property transferred to a surviving spouse could be increased by an additional \$3 million. Thus, the basis of property transferred to a surviving spouse could be increased by a total of \$4.3 million. In no case could the basis of an asset be adjusted above its fair market value. For these purposes, the executor would elect which assets receive an increase in basis and the extent to which each asset receives an increase in basis. The \$1.3 million and \$3 million amounts would be adjusted annually for inflation occurring after December 31, 2010.

Beginning in 2002 and through 2010, the estate and gift tax rates would be reduced, and the unified credit effective exemption amount for estate tax purposes and the generation-skipping

transfer tax exemption amount for deathtime transfers would be increased. Also in 2002, the unified credit effective exemption amount for gift tax purposes would be increased to and remain at \$1 million.

**Phase-out and repeal of estate and generation-skipping transfer taxes; phase-down of gift tax rates and increase in gift tax lifetime exclusion**

In 2002, the 5-percent surtax, which phases-out the benefit of the graduated rates, and the rates in excess of 50 percent would be repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) would be increased to \$1 million, and the state death tax credit would be reduced by 50 percent (from present-law amounts). In 2003, the estate and gift tax rates in excess of 49 percent would be repealed, and the state death tax credit would be reduced by 55 percent (from present-law amounts). In 2004, the estate and gift tax rates in excess of 48 percent would be repealed, the state death tax credit would be reduced by 56 percent (from-present law amounts), and the unified credit effective exemption amount for estate tax purposes would be increased to \$2 million. The gift tax unified credit effective exemption amount and the generation-skipping transfer tax exemption for lifetime transfers would remain at \$1 million. In addition, in 2004, the qualified family-owned business deduction would be repealed. In 2005, the estate and gift tax rates in excess of 47 percent and the state death tax credit would be repealed, and the unified credit effective exemption amount for estate tax purposes would be increased to \$3 million. In 2006, the estate and gift tax rates in excess of 46 percent would be repealed. In 2007, the estate and gift tax rates in excess of 45 percent would be repealed. In 2009, the unified credit effective exemption amount for estate tax purposes would be increased to \$3.5 million. In 2010, the unified credit effective exemption amount for estate tax purposes would be increased to \$4 million. In 2011, the estate and generation-skipping transfer taxes would be repealed. The generation-skipping transfer tax exemption for deathtime transfers and tax rate for a given year would equal the estate tax unified credit effective exemption amount and the highest estate and gift tax rate in effect for such year. The top gift tax rate would be 40 percent, beginning in 2011 and thereafter.

Table 8, below, summarizes the unified credit effective exemption amounts and the highest estate and gift tax rates under the proposal.

**Table 8.--Unified Credit Exemption Amounts and Highest Estate and Gift Tax Rates**

<b>Calendar Year</b>	<b>Estate and GST Tax deathtime transfer Exemption</b>	<b>Highest Estate and Gift Tax Rates</b>
2002	\$1 million	50%
2003	\$1 million	49%
2004	\$2 million	48%
2005	\$3 million	47%
2006	\$3 million	46%
2007	\$3 million	45%
2008	\$3.5 million	45%
2009	\$3.5 million	45%
2010	\$4 million	45%
2011	N/A (taxes repealed)	40% (gift tax only)

**Basis of property acquired from a decedent**

In general

Beginning in 2011, after the estate and generation-skipping transfer taxes have been repealed, the present-law rules providing for a fair market value basis for property acquired from a decedent would be repealed. Instead, a modified carryover basis regime generally would take effect. Recipients of property transferred at the decedent’s death would receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent’s death.

Basis increase for certain property

The proposal also would allow an executor to increase the decedent’s basis in assets transferred to beneficiaries at death. Under this rule, a decedent’s estate generally would be permitted to increase the basis of assets transferred by up to a total of \$1.3 million. The \$1.3 million would be increased by the amount of unused capital losses, net operating losses, and certain “built-in” losses of the decedent. In addition, the basis of property transferred to a surviving spouse could be increased by an additional \$3 million. Thus, the basis of property transferred to surviving spouses could be increased by a total of \$4.3 million. Basis increase would be allocable on an asset-by-asset basis (e.g., basis increase could be allocated to a share of stock or a block of stock). The decedent also would be treated as having owned the surviving spouse’s one-half share of community property, which would be eligible for a basis increase, if at least one-half of the property was owned by, and acquired from, the decedent. In no case could the basis of an asset be adjusted above its fair market value. For these purposes, the executor would elect which assets receive a step up in basis and determine the extent to which each asset receives an increase in basis. The \$1.3 million and \$3 million amounts are adjusted annually for inflation occurring after December 31, 2010.

Nonresidents who are not U.S. citizens would be allowed to increase the basis of property by up to \$60,000 (adjusted for inflation occurring after December 31, 2010).

Certain property would not be eligible for a basis increase. This includes: (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; (2) property that constitutes a right to receive income in respect of a decedent; (3) stock or securities of a foreign personal holding company; (4) stock of a domestic international sales corporation (or former domestic international sales corporation); (5) stock of a foreign investment company; and (6) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

The character of gain on the sale of property received from a decedent's estate would be treated the same as if the property had been acquired by gift. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent would be subject to recapture if sold by the heir.

## **Reporting requirements**

### **Transfers at death**

For transfers at death of non-cash assets in excess of \$1.3 million and for appreciated property the value of which exceeds \$25,000 received by a decedent within three years of death, the executor of the estate (or the trustee of a revocable trust) would report to the IRS:

- the name and taxpayer identification number of the recipient of the property,
- an accurate description of the property,
- the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- the decedent's holding period for the property,
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- the amount of basis increase allocated to the property, and
- any other information as the Treasury Secretary may prescribe.

Similar information (including the name, address, and phone number of the person making the return) would be required to be provided to recipients of such property.

### **Penalties for failure to file required information**

Any person required to report to the IRS transfers at death of non-cash assets in excess of \$1.3 million in value who fails to do so would be liable for a penalty of \$10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property valued in excess of \$25,000 within three years of death who fails to do so would be liable for a penalty of \$500 for the failure to report such information to the IRS. There also would be a penalty of \$50 for each failure to report such information to a beneficiary.

No penalty would be imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the proposal is due to intentional disregard of the rules, then the penalty would be five percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death).

### **Certain tax benefits extending past the date for repeal of the estate tax**

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax. Because repeal of the estate tax would be effective for decedents dying after December 31, 2010, these estate tax recapture provisions would continue to apply.

#### Qualified conservation easements

A donor may have retained a development right in the conveyance of a conservation easement that qualified for the estate tax exclusion. Those with an interest in the land may later execute an agreement to extinguish the right. If an agreement to extinguish development rights is not entered into within the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement, then those with an interest in the land are personally liable for an additional tax. This provision would be retained after repeal of the estate tax, which would ensure that those persons with an interest in the land who fail to execute the agreement remain liable for any additional tax which may be due after repeal.

#### Special-use valuation

Property may have qualified for special-use valuation prior to repeal of the estate tax. If such property ceases to qualify for special-use valuation, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the estate tax, which would ensure that those estates that claimed this benefit before repeal of the estate tax would be subject to recapture if a disqualifying event occurs after repeal.

#### Qualified family-owned business deduction

Property may have qualified for the family-owned business deduction prior to repeal of the qualified family-owned business deduction and estate tax. If such property ceases to qualify for the family-owned business deduction, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the qualified family-owned business deduction and estate tax, which would ensure that those estates that claimed this benefit before repeal of the qualified family-owned business deduction and estate tax would be subject to recapture if a disqualifying event occurs after repeal.

### Installment payment of estate tax for closely-held businesses

The present-law installment payment rules would be retained so that those estates that entered into an installment payment arrangement prior to repeal of the estate tax would continue to make their payments past the date for repeal.

If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. This rule would be retained after repeal of the estate tax, which would ensure that such dispositions that occur after repeal of the estate tax will continue to subject the estate to the unpaid portion of the tax upon notice and demand.

### Transfers to foreign trusts, estates, and nonresidents who are not U.S. citizens

The present-law rule providing that transfers by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange would be expanded. Under the proposal, transfers by a U.S. person to a nonresident who is not a U.S. citizen would be treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

### Transfers of property in satisfaction of a pecuniary bequest

Under the proposal, gain or loss on the transfer of property in satisfaction of a pecuniary bequest would be recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

### Transfer of property subject to a liability

The proposal would clarify that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in that property. Similarly, no gain would be recognized by the estate on the distribution of such property to a beneficiary of the estate by reason of the liability.

### Income tax exclusion for the gain on the sale of a principal residence

The income tax exclusion of up to \$250,000 of gain on the sale of a principal residence would be extended to estates and heirs. Under the proposal, if the decedent's estate or an heir sells the decedent's principal residence, \$250,000 of gain may be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of occupancy of the property as a principal residence may be added to the heir's subsequent occupancy in determining whether the property was occupied for two years as a principal residence.

### **Excise tax on nonexempt trusts**

A split-interest trust would be subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.

### **Anti-abuse rules**

The Secretary of the Treasury would be given authority to treat a transfer that purports to be a gift as having never been transferred, if, in connection with such transfer (1) the transferor (or any person related to or designated by the transferor or such person) has received anything of value in connection with the transfer from the transferee directly or indirectly or (2) there is an understanding or expectation that the transferor (or any person related to or designated by the transferor or such person) will receive anything of value in connection with the transfer from the transferee directly or indirectly.

### **Study mandated by the proposal**

The proposal would require the Treasury Secretary to conduct a study of opportunities for avoidance of the income tax, if any, and potential increases in income tax revenues by reason of enactment of the proposal. The results of such study would be required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance no later than December 31, 2002.

### **Effective Date**

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount for deathtime transfers, and reductions in the state death tax credit would be phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001. The repeal of the qualified family-owned business deduction would be effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes would be repealed and the carryover basis regime would take effect for estates of decedents dying and generation-skipping transfers made after December 31, 2010. The provisions relating to purported gifts and recognition of gain on transfers to nonresidents noncitizens would be effective for transfers made after December 31, 2010.

## **B. Expand Availability of Estate Tax Exclusion for Conservation Easements**

### **Present Law**

#### **In general**

An executor may elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of \$400,000 in 2001 and \$500,000 in 2002 and thereafter. The exclusion percentage is reduced by two percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution of a qualified real property interest was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purposes.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property.

#### **Retained development rights**

The exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right would be the right to extract minerals from the land. If such development rights exist, then the value of the conservation easement must be reduced by the value of any retained development right.

If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, then the value of the easement need not be reduced by the development rights. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, then those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

### **Description of Proposal**

The proposal would expand availability of qualified conservation easements to any property within the United States that otherwise meets the requirements of a conservation easement. The proposal also would clarify that the date for determining easement compliance is the date on which the donation was made.

### **Effective Date**

The proposal would be effective for estates of decedents dying after December 31, 2000.

## C. Modify Generation-Skipping Transfer Tax Rules

### 1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips

#### Present Law

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person<sup>@</sup> (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of \$1 million (adjusted for inflation beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under present law) multiplied by the inclusion ratio.<sup>@</sup> The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of generation-skipping transfer exemption<sup>@</sup> allocated to a trust. The allocation of generation-skipping transfer exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual may elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that are not direct skips, the transferor must allocate generation-skipping transfer exemption--the allocation is not automatic. If generation-skipping transfer exemption is allocated on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time of the transfer. If, however, the allocation is not made on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the

value of the property at the time the allocation of generation-skipping transfer exemption was made.

Treas. Reg. 26.2632-1(d) further provides that any unused generation-skipping transfer exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused generation-skipping transfer exemption is allocated pro rata on the basis of the value of the property as finally determined for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused generation-skipping transfer exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

### **Description of Proposal**

Under the proposal, generation-skipping transfer tax exemption would be automatically allocated to transfers made during life that are indirect skips.<sup>6</sup> An indirect skip would be any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust would be defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before 1 or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;
- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals; the trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals;
- the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;
- the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or

- the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer exemption would be allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual would be able to elect not to have the automatic allocation rules apply to an indirect skip, and such elections would be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual would be able to elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and may elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election may be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

#### **Effective Date**

The proposal would apply to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

## **2. Retroactive allocation of the generation-skipping tax exemption**

### **Present Law**

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable termination or taxable distribution, generation-skipping transfer tax may be avoided.

A transferor likely will not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then generation-skipping transfer tax would be due even if the transferor had unused generation-skipping transfer tax exemption.

### **Description of Proposal**

Under the proposal, generation-skipping transfer tax exemption could be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor could allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The proposal would allow a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption would be allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

### **Effective Date**

The proposal would apply to deaths of non-skip persons occurring after December 31, 2000.

### **3. Severing of trusts holding property having an inclusion ratio of greater than zero**

#### **Present Law**

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a skip person (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of \$1 million (adjusted for inflation beginning in 1999) is provided for each person making generation-skipping transfers. The exemption may be allocated by a transferor (or his or her executor) to transferred property.

If the value of transferred property exceeds the amount of the generation-skipping transfer exemption allocated to that property, then the generation-skipping transfer tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55 percent) by the inclusion ratio and the value of the taxable property at the time of the taxable event. The inclusion ratio is the number one minus the applicable fraction. The applicable fraction is a fraction calculated by dividing the amount of the generation-skipping transfer exemption allocated to the property by the value of the property.

Under Treas. Reg. 26.2654-1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury regulations, however, a trustee cannot establish inclusion ratios of zero and one by severing a trust that is subject to the generation-skipping transfer tax after the trust has been created.

#### **Description of Proposal**

Under the proposal, a trust could be severed in a qualified severance. A qualified severance would be defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance would be a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share would have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the provision, a trustee may elect to sever a trust in a qualified severance at any time.

#### **Effective Date**

The provision would be effective for severances of trusts occurring after December 31, 2000.

#### **4. Modification of certain valuation rules**

##### **Present Law**

Under present law, the inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-skipping transfer tax exemption made to transfers at death. Treas. Reg. 26.2642-5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

##### **Description of Proposal**

Under the proposal, in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio would be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio would be its value at that time.

##### **Effective Date**

The proposal would be effective for transfers subject to estate or gift tax made after December 31, 2000.

## **5. Relief from late elections**

### **Present Law**

Under present law, an election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to the trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There generally is no statutory provision allowing relief for an inadvertent failure to make an affirmative election on a timely-filed gift tax return or a timely-filed estate tax return to allocate generation-skipping transfer tax exemption.

### **Description of Proposal**

Under the proposal, the Treasury Secretary would be authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief were granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

### **Effective Date**

The proposal would apply to transfers subject to estate or gift tax made after December 31, 2000.

## **6. Substantial compliance**

### **Present Law**

Under present law, there is no statutory rule providing that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

### **Description of Proposal**

Under the proposal, substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption would suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption would be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances would be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

### **Effective Date**

This proposal would apply to transfers subject to estate or gift tax made after December 31, 2000.

## **VI. PENSION AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS**

### **A. Individual Retirement Arrangements (“IRAs”)**

#### **Present Law**

##### **In general**

There are two general types of individual retirement arrangements (“IRAs”) under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contribution) differ.

##### **Traditional IRAs**

Under present law, an individual may make deductible contributions to an IRA up to the lesser of \$2,000 or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to \$2,000 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. If the individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the \$2,000 deduction limit is phased-out for taxpayers with adjusted gross income (“AGI”) over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

**Single Taxpayers**

<i>Taxable years beginning in:</i>	<i>Phase-out range</i>
2001.....	33,000-43,000
2002.....	34,000-44,000
2003.....	40,000-50,000
2004.....	45,000-55,000
2005 and thereafter.....	50,000-60,000

**Joint Returns**

<i>Taxable years beginning in:</i>	<i>Phase-out range</i>
2001.....	53,000-63,000
2002.....	54,000-64,000
2003.....	60,000-70,000
2004.....	65,000-75,000
2005.....	70,000-80,000
2006.....	75,000-85,000
2007 and thereafter.....	80,000-100,000

The AGI phase-out range for married taxpayers filing a separate return is \$0 to \$10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the \$2,000 deduction limit is phased-out for taxpayers with AGI between \$150,000 and \$160,000.

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

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59-1/2 are subject to an additional 10-percent early withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7-1/2 percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to \$10,000.

**Roth IRAs**

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of \$2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to \$2,000 for each spouse may be made

to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased-out for single individuals with AGI between \$95,000 and \$110,000 and for joint filers with AGI between \$150,000 and \$160,000.

Taxpayers with modified AGI of \$100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

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

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings, and subject to the 10-percent early withdrawal tax (unless an exception applies).<sup>26</sup> The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

### **Taxation of charitable contributions**

Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity, as well as the fair market value of contributions of property. The amount of the deduction otherwise allowable for the taxable year with respect to a charitable contribution may be reduced, depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.

For donations of cash by individuals, total deductible contributions to public charities may not exceed 50 percent of a taxpayer's adjusted gross income ("AGI") for a taxable year. To the extent a taxpayer has not exceeded the 50-percent limitation, contributions of cash to private foundations and certain other nonprofit organizations and contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's AGI. If a taxpayer makes a contribution in one year that exceeds the applicable 50-percent or 30-percent limitation, the excess amount of the contribution may be carried over and deducted during the next five taxable years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is adjusted annually for inflation annually for inflation. The threshold amount for 2001 is \$132,950

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<sup>26</sup> Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

(\$66,475 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. The effect of this reduction may be to limit a taxpayer's ability to deduct some of his or her charitable contributions.

## **Description of Proposal**

### **Increase in annual contribution limits**

The proposal would increase the maximum annual dollar contribution limit for IRA contributions from \$2,000 to \$2,500 for 2002 through 2005, \$3,000 for 2006 and 2007, \$3,500 for 2008 and 2009, \$4,000 for 2010, and \$5,000 for 2011. After 2011, the limit would be adjusted annually for inflation in \$500 increments.

### **Additional catch-up contributions**

The proposal would provide that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year would be increased by \$500 for 2002 through 2005, \$1000 for 2006 through 2009, \$1,500 for 2010, and \$2,000 for 2011 and thereafter.

### **Deemed IRAs under employer plans**

The proposal would provide that, if a qualified retirement plan or a section 403(b) annuity permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the qualified plan, section 403(b) annuity, or eligible deferred compensation plan of a State or local government (a "governmental section 457 plan") and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs the separate account or annuity would be deemed a traditional IRA or a Roth IRA for all purposes of the Code, as applicable. The deemed IRA, and contributions thereto, would not be subject to the Code rules pertaining to qualified plans, section 403(b) annuities, or governmental section 457 plans, as applicable. In addition, the deemed IRA, and contributions thereto, would not be taken into account in applying those rules to any other contributions under the qualified plan, section 403(b) annuity, or governmental section 457 plan. The deemed IRA, and contributions thereto, would be subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan or annuity, but would not be subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements that apply to pension plans.

The proposal would provide that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity would be deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs would apply. The deemed IRA, and contributions thereto, would not be subject to the Code rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and

contributions thereto, would not be taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, would be subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and would not be subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.<sup>27</sup> An eligible retirement plan would be a qualified plan (sec. 401(a)), tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan.

### **Tax-free IRA withdrawals for charitable purposes**

The proposal would provide an exclusion from gross income for qualified charitable distributions from an IRA: (1) to a charitable organization (as described in sec. 170(c)) to which deductible contributions may be made; (2) to a charitable remainder annuity trust or charitable remainder unitrust; (3) to a pooled income fund (as defined in sec. 642(c)(5)); or (4) for the issuance of a charitable gift annuity. The exclusion would apply with respect to distributions described in (2), (3), or (4) only if no person holds an income interest in the trust, fund, or annuity attributable to such distributions other than the IRA owner, his or her spouse, or a charitable organization.

In determining the character of distributions from a charitable remainder annuity trust or a charitable remainder unitrust to which a qualified charitable distribution from an IRA was made, the charitable remainder trust would be required to treat as ordinary income the portion of the distribution from the IRA to the trust which would have been includible in income but for the proposal, and as corpus any remaining portion of the distribution. Similarly, in determining the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the taxpayer would not be permitted to treat the portion of the distribution from the IRA that would have been taxable but for the proposal and which is used to purchase the annuity as an investment in the annuity contract.

A qualified charitable distribution would be any distribution from an IRA which is made after age 70-1/2, which qualifies as a charitable contribution (within the meaning of sec. 170(c)), and which is made directly to the charitable organization or to a charitable remainder annuity trust, charitable remainder unitrust, pooled income fund, or charitable gift annuity (as described above).<sup>28</sup> A taxpayer would not be permitted to claim a charitable contribution deduction for amounts transferred from his or her IRA to a charity or to a trust, fund, or annuity that, because of the proposal, are excluded from the taxpayer's income. Conversely, if the amounts transferred

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<sup>27</sup> The proposal would not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

<sup>28</sup> It is intended that, in the case of transfer to a trust, fund, or annuity, the full amount distributed from an IRA will meet the definition of a qualified charitable distribution if the charitable organization's interest in the distribution would qualify as a charitable contribution under section 170.

would otherwise be nontaxable, e.g., a qualified distribution from a Roth IRA, the regularly applicable deduction rules would apply.

### **Effective Date**

The proposal would generally be effective for taxable years beginning after December 31, 2001. The proposal relating to deemed IRAs under employer plans would be effective for plan years beginning after December 31, 2002. The proposal relating to tax-free IRA withdrawals for charitable purposes would be effective for taxable years beginning after December 31, 2009.

## **B. Pension Provisions**

### **1. Expanding coverage**

#### **(a) Increase in benefit and contribution limits**

##### **Present Law**

##### **In general**

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (sec. 401(a)(17)), the maximum amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a State or local government (sec. 457).

##### **Limitations on contributions and benefits**

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) \$35,000 (for 2001). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The \$35,000 limit is adjusted annually for inflation for cost-of-living adjustments in \$5,000 increments.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of average compensation, or (2) \$140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in \$5,000 increments.

Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.

##### **Compensation limitation**

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to \$170,000 (for 2001). The compensation limit is adjusted annually for inflation for cost-of-living adjustments in \$10,000 increments.

##### **Elective deferral limitations**

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to

the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a “section 401(k) plan”), a tax-sheltered annuity (“section 403(b) annuity”) or a salary reduction simplified employee pension plan (“SEP”) is \$10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,500 (for 2001). These limits are adjusted annually for inflation in \$500 increments.

### **Section 457 plans**

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a “section 457 plan”) is the lesser of (1) \$8,500 (for 2001) or (2) 33-1/3 percent of compensation. The \$8,500 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant’s last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

## **Description of Proposal**

### **Limits on contributions and benefits**

The proposal would provide faster annual adjusting for inflation of the \$35,000 limit on annual additions to a defined contribution plan. Under the proposal this limit amount would be adjusted annually for inflation in \$1,000 increments.<sup>29</sup>

The proposal would increase the \$140,000 annual benefit limit under a defined benefit plan to \$150,000 for 2002 through 2004 and to \$160,000 for 2005 and thereafter. The dollar limit would be reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

### **Compensation limitation**

The proposal would increase the limit on compensation that may be taken into account under a plan to \$180,000 for 2002, \$190,000 for 2003, and \$200,000 for 2004 and 2005. After 2005, this amount would be adjusted annually for inflation in \$5,000 increments.

### **Elective deferral limitations**

In 2002, the proposal would increase the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities, and salary reduction SEPs to \$11,000. In 2003

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<sup>29</sup> The 25 percent of compensation limitation would be increased to 100 percent of compensation under another provision of the proposal.

and thereafter, the limits would increase in \$500 annual increments until the limits reach \$15,000 in 2010, with annual adjustments for inflation in \$500 increments thereafter. The proposal would increase the maximum annual elective deferrals that may be made to a SIMPLE plan to \$7,000 for 2002 and 2003, \$8,000 for 2004 and 2005, \$9,000 for 2006 and 2007, and \$10,000 for 2008. After 2008, the \$10,000 dollar limit would be adjusted annually for inflation in \$500 increments.

### **Section 457 plans**

The dollar limit on deferrals under a section 457 plan would be increased to \$9,000 in 2002, and would be increased in \$500 annual increments thereafter until the limit reaches \$11,000 in 2006. Beginning in 2007, the limit would be increased in \$1,000 annual increments until it reaches \$15,000 in 2010. After 2010, the limit would be adjusted annually for inflation thereafter in \$500 increments. The limit would be twice the otherwise applicable dollar limit in the three years prior to retirement.<sup>30</sup>

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(b) Plan loans for subchapter S shareholders, partners, and sole proprietors**

### **Present Law**

The Internal Revenue Code prohibits certain transactions (“prohibited transactions”) between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.<sup>31</sup> Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if she finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee.<sup>32</sup> Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably

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<sup>30</sup> Another proposal would increase the 33-1/3 percentage of compensation limit to 100 percent.

<sup>31</sup> Title I of the Employee Retirement Income Security Act of 1974, as amended (“ERISA”), also contains prohibited transaction rules. The Code and ERISA provisions are substantially similar, although not identical.

<sup>32</sup> Certain transactions involving a plan and Subchapter S shareholders are permitted.

equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than 5 percent of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement (“IRA”). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 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 equal to 100 percent of the amount involved.

### **Description of Proposal**

The proposal generally would eliminate the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption would apply to such transactions. Present law would continue to apply with respect to IRAs.

### **Effective Date**

The proposal would be effective with respect to years beginning after December 31, 2001.

### **(c) Modification of top-heavy rules**

### **Present Law**

#### **In general**

Under present law, additional qualification requirements apply to plans that primarily benefit an employer’s key employees (“top-heavy plans”). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

#### **Definition of top-heavy plan**

A defined benefit plan is a top-heavy plan if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year (“the determination date”).

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the 5-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the 5-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

### **Definition of key employee**

A key employee is an employee who, during the plan year that ends on the determination date or any of the 4 preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 (\$70,000 for 2001), (2) a 5-percent owner of the employer, (3) a 1-percent owner of the employer earning over \$150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit (\$35,000 for 2001) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1-percent owner status, 5-percent owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

### **Minimum benefit for non-key employees**

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) 2 percent of compensation multiplied by the employee's years of service, or (2) 20 percent of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) 3 percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to

employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).<sup>33</sup>

### **Top-heavy vesting**

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) 3-year cliff vesting, which provides for 100 percent vesting after 3 years of service; and (2) 2-6 year graduated vesting, which provides for 20 percent vesting after 2 years of service, and 20 percent more each year thereafter so that a participant is fully vested after 6 years of service.<sup>34</sup>

### **Qualified cash or deferred arrangements**

Under a qualified cash or deferred arrangement (a “section 401(k) plan”), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the “ADP” test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the “ACP” test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least 3 percent of an employee’s compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement without regard to the permitted disparity rules (sec. 401(1)). A plan satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee’s elective deferrals up to 3 percent of compensation and (b) 50 percent of the employee’s elective deferrals from 3 to 5 percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred

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<sup>33</sup> Treas. Reg. sec. 1.416-1 Q&A M-19.

<sup>34</sup> Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules: (1) 5-year cliff vesting; and (2) 3-7 year graded vesting, which provides for 20 percent vesting after 3 years and 20 percent more each year thereafter so that a participant is fully vested after 7 years of service.

arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

## **Description of Proposal**

### **Definition of top-heavy plan**

In determining whether a plan is top-heavy, the proposal would provide that distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law 5-year rule would apply with respect to in-service distributions. Similarly, the proposal would provide that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the 1-year period ending on the date the top-heavy determination is being made.

### **Definition of key employee**

The proposal would (1) provide that an employee is not considered a key employee by reason of officer status unless the employee earns more than the compensation limit for determining whether an employee is highly compensated (\$85,000 for 2001)<sup>35</sup> and (2) repeal the top-10 owner key employee category. The proposal would repeal the 4-year lookback rule for determining key employee status and provide that an employee is a key employee only if he or she is a key employee during the preceding plan year. An employee who was not an employee in the preceding plan year, or who was an employee only for part of the year, would be treated as a key employee if it could be reasonably anticipated that the employee would meet the definition of a key employee for current plan year.

Thus, under the proposal, an employee generally would be considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of \$85,000, (2) a 5-percent owner, or (3) a 1-percent owner with compensation in excess of \$150,000. The present-law limits on the number of officers treated as key employees under (1) would continue to apply.

### **Minimum benefit for nonkey employees**

Under the proposal, matching contributions would be taken into account in determining whether the minimum benefit requirement has been satisfied.<sup>36</sup>

The proposal would provide that, in determining the minimum benefit required under a defined benefit plan, a year of service would not include any year in which no key employee or former key employee benefits under the plan (as determined under sec. 410).

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<sup>35</sup> The compensation limit would be determined without regard to the top-paid group election.

<sup>36</sup> Thus, this proposal would override the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(d) Elective deferrals not taken into account for purposes of deduction limits**

#### **Present Law**

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

#### **Description of Proposal**

Under the proposal, the applicable percentage of elective deferral contributions would not be subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan would not take into account the applicable percentage of elective deferral contributions. The applicable percentage would be 25 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

**(e) Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations**

**Present Law**

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local government employer (a “section 457 plan”) is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,500 (in 2001) or (2) 33-1/3 percent of compensation. The \$8,500 limit is increased for inflation in \$500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant’s last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The \$8,500 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the \$8,500 limit, contributions under a tax-sheltered annuity (“section 403(b) annuity”), elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), salary reduction contributions under a simplified employee pension plan (“SEP”), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

**Description of Proposal**

The proposal would repeal the rules coordinating the section 457 dollar limit with contributions under other types of plans.<sup>37</sup>

**Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

**(f) Deduction limits**

**Present Law**

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan’s unfunded current liabilities.

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<sup>37</sup> The limits on deferrals under a section 457 plan would be modified under other provisions of the proposal.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25 percent of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement ("section 401(k) plan") are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.<sup>38</sup>

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution.<sup>39</sup> An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefiting under the arrangement even if the employee elects not to defer.<sup>40</sup>

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

### **Description of Proposal**

Under the proposal, the definition of compensation for purposes of the deduction rules would include salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan would be increased from 15 percent to 25 percent of compensation of the employees

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<sup>38</sup> Another proposal would provide that elective deferrals are not subject to the deduction limits.

<sup>39</sup> Rev. Rul. 65-295, 1965-2 C.B. 148.

<sup>40</sup> Treas. Reg. sec. 1.410(b)-3.

covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan would be treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(g) Option to treat elective deferrals as after-tax Roth contributions**

#### **Present Law**

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation ("excess deferrals") are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation ("excess deferrals"), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than the March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed. The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income and are not subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59-1/2, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to \$10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in

income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).<sup>41</sup>

### **Description of Proposal**

A section 401(k) plan or a section 403(b) annuity would be permitted to include a “Roth contribution program” that permits a participant to elect to have all or a portion of the participant’s elective deferrals under the plan treated as Roth contributions. Roth contributions would be elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe)<sup>42</sup> as not excludable from the participant’s gross income.

The annual dollar limitation on a participant’s Roth contributions would be the section 402(g) annual limitation on elective deferrals, reduced by the participant’s elective deferrals that the participant does not designate as Roth contributions. Roth contributions would be treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions.<sup>43</sup> Under a section 401(k) plan, Roth contributions also would be treated as any other elective deferral for purposes of the special nondiscrimination requirements.<sup>44</sup>

The plan would be required to establish a separate account, and maintain separate recordkeeping, for a participant’s Roth contributions (and earnings allocable thereto). A qualified distribution from a participant’s Roth contributions account would not be includible in the participant’s gross income. A qualified distribution would be a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59-1/2, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant’s being disabled.<sup>45</sup> The nonexclusion period would be the 5-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a Roth contribution to any Roth contribution account

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<sup>41</sup> Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

<sup>42</sup> It would be intended that the Secretary would generally not permit retroactive designations of elective deferrals as Roth contributions.

<sup>43</sup> Similarly, Roth contributions to a section 403(b) annuity would be treated the same as other salary reduction contributions to the annuity (except that Roth contributions would be includible in income).

<sup>44</sup> It would be intended that the Secretary would provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and Roth contributions. It would be intended that such rules would generally permit a plan to allow participants to designate which contributions would be returned first or to permit the plan to specify which contributions would be returned first.

<sup>45</sup> A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a Roth contributions account.

established for the participant under the plan, or (2) if the participant has made a rollover contribution to the Roth contribution account that is the source of the distribution from a Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a Roth contribution to the previously established account.

A distribution from a Roth contributions account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to sec. 401(k)(8) (and income allocable thereto) would not be a qualified distribution. In addition, the treatment of excess Roth contributions would be similar to the treatment of excess deferrals attributable to non-Roth contributions. If excess Roth contributions (including earnings thereon) are distributed no later than the April 15<sup>th</sup> following the taxable year, then the Roth contributions would not be includible in gross income as a result of the distribution, because such contributions would be includible in gross income when made. Earnings on such excess Roth contributions would be treated the same as earnings on excess deferrals distributed no later than April 15<sup>th</sup>, i.e., they would be includible in income when distributed. If excess Roth contributions are not distributed no later than the applicable April 15<sup>th</sup>, then such contributions (and earnings thereon) would be taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15<sup>th</sup>, the contributions would be includible in income in the year when made and again when distributed from the plan. Earnings on such contributions would be taxable when received.

A participant would be permitted to roll over a distribution from a Roth contributions account only to another Roth contributions account or a Roth IRA of the participant.

The Secretary of the Treasury would be directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make Roth contributions to make such returns and reports regarding Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

#### **Effective Date**

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

#### **(h) Nonrefundable credit to certain individuals for elective deferrals and IRA contributions**

#### **Present Law**

Present law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements (“IRAs”).

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions (“SEPs”), section 408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain

cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries.<sup>46</sup> Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to \$2,000 (or the compensation of the individual or the individual's spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual's adjusted gross income ("AGI") is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional IRA is includible in the individual's gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59-1/2 are subject to a 10-percent additional tax, unless an exception applies.

### **Description of Proposal**

The proposal would provide a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit would be \$2,000. The credit rate would depend on the adjusted gross income ("AGI") of the taxpayer. Only joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less would be eligible for the credit. The AGI limits applicable to single taxpayers would apply to married taxpayers filing separate returns. The credit would be in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit would offset minimum tax liability as well as regular tax liability. The credit would be available to individuals 18 or over and have not attained age 60, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit would be available with respect to elective contributions to a section 401(k) plan, section 403(b) annuity, or eligible deferred compensation arrangement of a State or local government (a "sec. 457 plan"), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and

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<sup>46</sup> In the case of after-tax employee contributions, only earnings are taxed upon withdrawal.

voluntary after-tax employee contributions to a qualified retirement plan. The present-law rules governing such contributions would continue to apply.

The amount of any contribution eligible for the credit would be reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan during the taxable year for which the credit is claimed, the two taxable years prior to the year the credit is claimed, and during the period after the end of the taxable year and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule would apply to any such distributions, whether or not taxable.

The credit rates based on AGI would be as follows.

<i>Joint Filers</i>	<i>Heads of Households</i>	<i>All Other Filers</i>	<i>Credit Rate</i>
\$0-\$30,000	\$0-\$22,500	\$0-\$15,000	50 percent
\$30,000-\$32,500	\$22,500-\$24,375	\$15,000-\$16,250	20 percent
\$32,500-\$50,000	\$24,375-\$37,500	\$16,250-\$25,000	10 percent
Over \$50,000	Over \$37,500	Over \$25,000	0 percent

The proposal would direct the Secretary of the Treasury to report annually to the Senate Finance Committee and the House Committee on Ways and Means regarding the number of individuals who claim the credit.

#### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001, and before January 1, 2007.

#### **(i) Small business tax credit for qualified retirement plan contributions**

##### **Present Law**

The timing of an employer's deduction for compensation paid to an employee generally corresponds to the employee's recognition of the compensation. However, an employer that contributes to a qualified retirement plan is entitled to a deduction (within certain limits) for the employer's contribution to the plan on behalf of an employee even though the employee does not recognize income with respect to the contribution until the amount is distributed to the employee.

##### **Description of Proposal**

The proposal would provide a nonrefundable income tax credit for small employers equal to 50 percent of certain qualifying employer contributions made to qualified retirement plans on behalf of nonhighly compensated employees. The credit would not be available with respect to contributions to a SIMPLE IRA or SEP. For purposes of the proposal, a small employer would mean an employer with no more than 20 employees who received at least \$5,000 of earnings in the preceding year. A nonhighly compensated employee would be defined as an employee who neither (1) was a five-percent owner of the employer at any time during the current year or the preceding year, or (2) for the preceding year, had compensation in excess of \$80,000 (adjusted

annually for inflation, this amount is \$85,000 for 2001).<sup>47</sup> The credit would be available for the first three plan years of the plan.

The proposal would require a small employer to make nonelective contributions equal to at least one percent of compensation to qualify for the credit. The credit would apply to both qualifying nonelective employer contributions and qualifying employer matching contributions, but only up to a total of three percent of the nonhighly compensated employee's compensation. The credit would be available for 50 percent of qualifying benefit accruals under a nonintegrated defined benefit plan if the benefits are equivalent, as defined in regulations, to a three-percent nonelective contribution to a defined contribution plan.

To qualify for the credit, the nonelective and matching contributions to a defined contribution plan and the benefit accruals under a defined benefit plan would be required to vest at least as rapidly as under either a three-year cliff vesting schedule or a graded schedule that provides 20-percent vesting per year for five years. In order to qualify for the credit, contributions to plans other than pension plans would have to be subject to the same distribution restrictions that apply to qualified nonelective employer contributions to a section 401(k) plan, i.e., distribution only upon separation from service, death, disability, attainment of age 59-1/2, plan termination without a successor plan, or acquisition of a subsidiary or substantially all the assets of a trade or business that employs the participant.<sup>48</sup> Qualifying contributions to pension plans would be subject to the distribution restrictions applicable to such plans.

The plan to which the small employer makes the qualifying contributions (and any plan aggregated with that plan for nondiscrimination testing purposes) would be required to allocate any nonelective employer contributions proportionally to participants' compensation from the employer (or on a flat-dollar basis) and, accordingly, without the use of permitted disparity or cross-testing.

Forfeited nonvested qualifying contributions or accruals for which the credit was claimed generally would result in recapture of the credit at a rate of 35 percent. However, recapture would not apply to the extent that forfeitures of contributions are reallocated to nonhighly compensated employees or applied to future contributions on behalf of nonhighly compensated employees. The Secretary of the Treasury would be authorized to issue administrative guidance, including de minimis rules, to simplify or facilitate claiming and recapturing the credit.

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<sup>47</sup> The top paid group election, which under present law permits an employer to classify an employee as a nonhighly compensated employee if the employee had compensation in excess of \$80,000 (adjusted annually for inflation) during the preceding year but was not among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to employees during the preceding year, would not be taken into account in determining nonhighly compensated employees for purposes of the proposal.

<sup>48</sup> The rules relating to distribution upon separation from service would be modified under another provision of the proposal.

The credit would be a general business credit.<sup>49</sup> The 50 percent of qualifying contributions that are effectively offset by the tax credit would not be deductible; the other 50 percent of the qualifying contributions (and other contributions) would be deductible to the extent permitted under present law.

### **Effective Date**

The credit would be effective with respect to contributions paid or incurred in taxable years beginning after December 31, 2002, with respect to plans established after such date.

### **(j) Small business tax credit for new retirement plan expenses**

#### **Present Law**

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

#### **Description of Proposal**

The proposal would provide a nonrefundable income tax credit for 50 percent of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or simplified employee pension (“SEP”). The credit would apply to 50 percent of the first \$1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit would be available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in excess of \$5,000. In order for an employer to be eligible for the credit, the plan would have to cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement would have to be made available to all employees of the employer who have worked with the employer for at least three months.

The credit would be a general business credit.<sup>50</sup> The 50 percent of qualifying expenses that are effectively offset by the tax credit would not be deductible; the other 50 percent of the qualifying expenses (and other expenses) would be deductible to the extent permitted under present law.

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<sup>49</sup> The credit could not be carried back to years before the effective date.

<sup>50</sup> The credit could not be carried back to years before the effective date.

### **Effective Date**

The credit would be effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

### **(k) Eliminate IRS user fees for certain determination letter requests regarding employer plans**

### **Present Law**

An employer that maintains a retirement plan for the benefit of its employees may request from the Internal Revenue Service (“IRS”) a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (sec. 401(a)). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The user fee may range from \$125 to \$1,250, depending upon the scope of the request and the type and format of the plan.<sup>51</sup>

Present law provides that plans that do not meet the qualification requirements will be treated as meeting such requirements if appropriate retroactive plan amendments are made during the remedial amendment period. In general, the remedial amendment period ends on the due date for the employer's tax return (including extensions) for the taxable year in which the event giving rise to the disqualifying provision occurred (e.g., a plan amendment or a change in the law). The Secretary may provide for general extensions of the remedial amendment period or for extensions in certain cases. For example, the remedial amendment period with respect to amendments relating to the qualification requirements affected by the General Agreements on Tariffs and Trade, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998 generally ends the last day of the first plan year beginning on or after January 1, 2001.<sup>52</sup>

### **Description of Proposal**

An eligible employer would not be required to pay a user fee for a determination letter request with respect to the qualified status of a new retirement plan that the employer maintains and with respect to which the employer has not previously made a determination letter request. An employer would be eligible under the proposal if (1) the employer has no more than 100 employees, (2) the employer has at least one nonhighly compensated employee, and (3) during the three-taxable year period immediately preceding the taxable year in which the request is

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<sup>51</sup> Authorization for the user fees was originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100-203, December 22, 1987). The authorization was extended through September 30, 2003, by Public Law Number 104-117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)).

<sup>52</sup> Rev. Proc. 2000-27, 2000-26 I.R.B. 1272.

made, neither the employer nor a related employer established or maintained a qualified plan with respect to which contributions were made or benefits were accrued for substantially the same employees covered under the plan with respect to which the request is made. The proposal would apply only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan would be required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. An employer that adopts a prototype plan, however, would not be required to pay a user fee for a determination letter request with respect to the employer's plan.

### **Effective Date**

The proposal would be effective for determination letter requests made after December 31, 2001.

## **2. Enhancing fairness for women**

### **(a) Additional salary reduction catch-up contributions**

#### **Present Law**

##### **Elective deferral limitations**

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is \$10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is \$6,500 (for 2001). These limits are adjusted annually for inflation in \$500 increments.

##### **Section 457 plans**

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) \$8,500 (for 2001) or (2) 33-1/3 percent of compensation. The \$8,500 dollar limit is increased for inflation in \$500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last 3 years before retirement, the otherwise applicable limit is increased to the lesser of (1) \$15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

## Description of Proposal

The proposal would provide that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a section 457 plan would be increased for individuals who have attained age 50 by the end of the year.<sup>53</sup> Additional contributions could be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under the proposal, the additional amount of elective contributions that could be made by an eligible individual participating in such a plan would be the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year.<sup>54</sup> The applicable dollar amount would be \$500 for 2002 through 2004, \$1,000 for 2005 and 2006, \$2,000 for 2007, \$3,000 for 2008, \$4,000 for 2009, and \$7,500 for 2010 and thereafter.

Catch-up contributions made under the proposal would not be subject to any other contribution limits and would not be taken into account in applying other contribution limits. In addition, such contributions would not be subject to applicable nondiscrimination rules.<sup>55</sup>

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

The following examples illustrate the application of the proposal, after the catch-up is fully phased-in.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the proposal) is \$10,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is \$8,000. Under the proposal, A would be able to make additional catch-up salary reduction contributions of \$5,000.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is \$30,000. The maximum annual deferral limit (without regard to the proposal) is \$10,000. Under the terms of the plan, the maximum permitted deferral is 10 percent

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<sup>53</sup> Another proposal would increase the dollar limit on elective deferrals under such arrangements.

<sup>54</sup> In the case of a section 457 plan, this catch-up rule would not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit would be doubled).

<sup>55</sup> Another proposal would increase the dollar limit on elective deferrals under such arrangements.

of compensation or, in B's case, \$3,000. Under the proposal, B can contribute up to \$8,000 for the year (\$3,000 under the normal operation of the plan, and an additional \$5,000 under the proposal).

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001.

### **(b) Equitable treatment for contributions of employees to defined contribution plans**

### **Present Law**

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

### **Defined contribution plans**

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of \$35,000 (for 2001) or 25 percent of the employee's compensation (sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

### **Tax-sheltered annuities**

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of

compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant's includible compensation; or (3) \$15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

### **Section 457 plans**

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local governmental employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) \$8,500 (in 2001) or (2) 33-1/3 percent of compensation. The \$8,500 limit is increased for inflation in \$500 increments.

## **Description of Proposal**

### **Increase in defined contribution plan limit**

The proposal would increase the 25 percent of compensation limitation on annual additions under a defined contribution plan to 50 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.<sup>56</sup>

### **Conforming limits on tax-sheltered annuities**

The proposal would repeal the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities would be subject to the limits applicable to tax-qualified plans.

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<sup>56</sup> Another proposal would increase the defined contribution plan dollar limit.

The proposal also would direct the Secretary of the Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. For taxable years beginning after December 31, 2000, the regulatory provisions regarding the exclusion allowance would be applied as if the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance were void.

### **Section 457 plans**

The proposal would increase the 33-1/3 percent of compensation limitation on deferrals under a section 457 plan to 50 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.

### **Effective Date**

The proposal generally would be effective for years beginning after December 31, 2001. The proposal regarding the regulations under section 403(b)(2) would be effective on the date of enactment.

### **(c) Faster vesting of employer matching contributions**

#### **Present Law**

Under present law, 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.<sup>57</sup>

#### **Description of Proposal**

The proposal would apply faster vesting schedules to employer matching contributions. Under the proposal, employer matching contributions would have to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan would satisfy 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 would satisfy 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.

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<sup>57</sup> The minimum vesting requirements are also contained in Title I of ERISA.

## Effective Date

The proposal would be effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. The proposal would 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 would be taken into account.

### **(d) Simplify the minimum distribution rules**

## Present Law

### In general

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements (“IRAs”), tax-sheltered annuities (“section 403(b) annuities”), and eligible deferred compensation plans of tax-exempt and State and local government employers (“section 457 plans”). In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the individual plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Commissioner that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under proposed Treasury regulations.

### Distributions prior to the death of the individual

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

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70-1/2 or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70-1/2. If commencement of benefits is delayed beyond age 70-1/2 from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account

the period after age 70-1/2 in which the employee was not receiving benefits under the plan.<sup>58</sup> In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 following the calendar year in which the IRA owner attains age 70-1/2. The pre-death minimum distribution rules do not apply to Roth IRAs.

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

### **Distributions after the death of the plan participant**

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 1 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 distribution until the date the deceased participant would have attained age 70-1/2.

### **Special rules for section 457 plans**

Eligible deferred compensation plans of State and local and tax-exempt employers ("section 457 plans") are subject to the minimum distribution rules described above. Such plans are also subject to additional minimum distribution requirements (sec. 457(d)(2)(b)).

### **Description of Proposal**

The proposal would apply the present-law rules applicable if the participant dies before distribution of minimum benefits has begun to all post-death distributions. Thus, in general, if the employee dies before his or her entire interest has been distributed, distribution of the remaining interest would be required to be made within five years of the date of death, or begin within one year of the date of death and paid over the life or life expectancy of a designated beneficiary. In the case of a surviving spouse, distributions would not be required to begin until the surviving spouse attains age 70-1/2. The proposal would include a transition rule with respect to the provision providing that the required beginning date in the case of a surviving spouse is no earlier than the April 1 of the calendar year following the calendar year in which the surviving spouse attains age 70-1/2. In the case of an individual who died before the date of

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<sup>58</sup> State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70-1/2.

enactment and prior to his or her required beginning date and whose beneficiary is the surviving spouse, minimum distributions to the surviving spouse would not be required to begin earlier than the date distributions would have been required to begin under present law.

In addition, the Treasury would be directed to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(e) Clarification of tax treatment of division of section 457 plan benefits upon divorce**

#### **Present Law**

Under present law, benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order (“QDRO”). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan (“section 457 plan”) of a tax-exempt or State and local government employer. The QDRO rules do not apply to section 457 plans.

#### **Description of Proposal**

The proposal would apply the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan would not be treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans would apply for purposes of determining whether a distribution is pursuant to a QDRO.

### **Effective Date**

The proposal relating to tax treatment of distributions made pursuant to a domestic relations order from a section 457 plan would be effective for transfers, distributions, and payments made after December 31, 2001. The proposals relating to the waiver of restrictions on distributions and the application of the special rule for determining whether a distribution is pursuant to a QDRO would be effective on January 1, 2002, except that in the case of a domestic relations order entered before January 1, 2002, the plan administrator (1) would be required to treat such order as a QDRO if the administrator is paying benefits pursuant to such order on January 1, 2002, and (2) would be permitted to treat any other such order entered before January 1, 2002, as a QDRO even if such order does not meet the relevant requirements of the proposal.

#### **(f) Modifications relating to hardship withdrawals**

### **Present Law**

Elective deferrals under a qualified cash or deferred arrangement (a “section 401(k) plan”) may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations<sup>59</sup> provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

Under present law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20-percent. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10 percent. In either case, the individual may elect not to have withholding apply.

### **Description of Proposal**

The Secretary of the Treasury would be directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be

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<sup>59</sup> Treas. Reg. sec. 1.401(k)-1.

deemed necessary to satisfy an immediate and heavy financial need. The revised regulations would be effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee would not be an eligible rollover distribution. Thus, such distributions would not be permitted to be rolled over, and would be subject to the withholding rules applicable to distributions that are not eligible rollover distributions. The proposal would not modify the rules under which hardship distributions may be made. For example, as under present law, hardship distributions of qualified employer matching contributions would only be permitted under the rules applicable to elective deferrals.

The proposal would be intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, would be ineligible for rollover. This rule would be intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan would be permitted to treat the distribution in its entirety as made upon hardship of the employee.

#### **Effective Date**

The proposal directing the Secretary to revise the rules relating to safe harbor hardship distributions would be effective on the date of enactment. The proposal providing that hardship distributions are not eligible rollover distributions would be effective distributions made after December 31, 2001. The Secretary would have the authority to issue transitional guidance with respect to the proposal providing that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

#### **(g) Pension coverage for domestic and similar workers**

##### **Present Law**

Under present law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exception, a 10-percent excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible and therefore are subject to the excise tax on nondeductible contributions.

## **Description of Proposal**

Under the proposal, the 10-percent excise tax on nondeductible contributions would not apply to contributions to a SIMPLE plan or a SIMPLE individual retirement account, which are nondeductible solely because the contributions are not a trade or business expense under section 162. Thus, for example, employers of household workers would be able to make contributions to such plans without imposition of the excise tax. As under present law, the contributions would not be deductible. The present-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, would continue to apply. The proposal would not apply with respect to contributions on behalf of the individual and members of his or her family.

## **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001.

### **3. Increasing portability for participants**

#### **(a) Rollovers of retirement plan and IRA distributions**

## **Present Law**

### **In general**

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

### **Distributions from qualified plans**

Under present law, an “eligible rollover distribution” from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement (“IRA”)<sup>60</sup> or another qualified plan.<sup>61</sup> An “eligible rollover distribution” means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee’s designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution

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<sup>60</sup> A “traditional” IRA refers to IRAs other than Roth IRAs or SIMPLE IRAs. All references to IRAs refer only to traditional IRAs.

<sup>61</sup> An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan.

includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

### **Distributions from tax-sheltered annuities**

Eligible rollover distributions from a tax-sheltered annuity (“section 403(b) annuity”) may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

### **IRA distributions**

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called “conduit IRAs.” Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

### **Distributions from section 457 plans**

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. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

### **Rollovers by surviving spouses**

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

### **Direct rollovers and withholding requirements**

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.

## **Notice of eligible rollover distribution**

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

## **Taxation of distributions**

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10-percent early withdrawal tax if made before age 59-1/2. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10-percent early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10-percent early withdrawal tax does not apply to section 457 plans.

## **Description of Proposal**

### **In general**

The proposal would provide that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally could be rolled over to any of such plans or arrangements.<sup>62</sup> Similarly, distributions from an IRA generally would be permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules would be extended to distributions from a governmental section 457 plan, and such plans would be required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) would be required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to distributions from the distributing plan.

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<sup>62</sup> Hardship distributions from governmental section 457 plans would be considered eligible rollover distributions.

Qualified plans, section 403(b) annuities, and section 457 plans would not be required to accept rollovers.

Some special rules would apply in certain cases. A distribution from a qualified plan would not be eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover would have to be made to a “conduit IRA” as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan would be subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans would be required to separately account for such amounts.

### **Rollover of after-tax contributions**

The proposal would provide that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover would be permitted to be accomplished only through a direct rollover. In addition, a qualified plan would not be permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) would not be permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution would be attributed first to amounts other than after-tax contributions.

### **Expansion of spousal rollovers**

The proposal would provide that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the spouse participates.

### **Treasury regulations**

The Secretary would be directed to prescribe rules necessary to carry out the proposals. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It would be anticipated that the IRS would develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606 - Nondeductible IRAs, to include information regarding after-tax contributions.

### **Effective Date**

The proposal would be effective for distributions made after December 31, 2001.

## **(b) Waiver of 60-day rule**

### **Present Law**

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

### **Description of Proposal**

The proposal would provide that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement.

### **Effective Date**

The proposal would apply to distributions made after December 31, 2001.

## **(c) Treatment of forms of distribution**

### **Present Law**

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit (sec. 411(d)(6)).<sup>63</sup>

Under regulations recently issued by the Secretary,<sup>64</sup> this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status.

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<sup>63</sup> A similar provision is contained in Title I of ERISA.

<sup>64</sup> Treas. Reg. sec. 1.411(d)-4, Q&A-2(e) and Q&A-(3)(b).

## **Description of Proposal**

A defined contribution plan to which benefits are transferred would not be treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution.

Furthermore, the proposal would direct the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It would be intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant would include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

The Secretary would be directed to issue, not later than December 31, 2002, final regulations under section 411(d)(6), including regulations required under the proposal.

## **Effective Date**

The proposal would be effective for years beginning after December 31, 2001, except that the direction to the Secretary would be effective on the date of enactment.

#### **(d) Rationalization of restrictions on distributions**

##### **Present Law**

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”), tax-sheltered annuity (“section 403(b) annuity”), or an eligible deferred compensation plan of a tax-exempt organization or State or local government (“section 457 plan”), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include “separation from service.”

A separation from service occurs only upon a participant’s death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called “same desk rule,” a participant’s severance from employment does not necessarily result in a separation from service.

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred to another employer in connection with a sale of less than substantially all the assets of a trade or business.<sup>65</sup>

##### **Description of Proposal**

The proposal would modify the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation’s disposition of its assets or a subsidiary would be repealed; this special rule would no longer be necessary under the proposal.

##### **Effective Date**

The proposal would be effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

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<sup>65</sup> Rev. Rul. 2000-27, 2000-21 I.R.B. 1016.

### **(e) Purchase of service credit under governmental pension plans**

#### **Present Law**

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 (sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan 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.

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.

A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity (“section 403(b) annuity”) or an eligible deferred compensation plan of a tax-exempt organization of a State or local government (“section 457 plan”) to purchase permissive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

#### **Description of Proposal**

A participant in a State or local governmental plan would not be 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 credits 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).

#### **Effective Date**

The proposal would be effective for transfers after December 31, 2001.

### **(f) Employers may disregard rollovers for purposes of cash-out rules**

#### **Present Law**

If an 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 and, if applicable, the participant’s spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service

with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.<sup>66</sup>

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.<sup>67</sup>

### **Description of Proposal**

A plan would be permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

### **Effective Date**

The proposal would be effective for distributions after December 31, 2001.

### **(g) Minimum distribution and inclusion requirements for section 457 plans**

#### **Present Law**

A "section 457 plan" is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Amounts deferred under a section 457 plan are generally includible in income when paid or made available. Amounts deferred under a plan of deferred compensation of a State or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available.<sup>68</sup>

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, such plans are subject to additional minimum distribution rules (sec. 457(d)(2)(B)).

### **Description of Proposal**

The proposal would provide that amounts deferred under a section 457 plan of a State or local government are includible in income when paid. The proposal also would repeal the special minimum distribution rules applicable to section 457 plans. Thus, such plans would be subject to the minimum distribution rules applicable to qualified plans.

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<sup>66</sup> A similar provision is contained in Title I of ERISA.

<sup>67</sup> Other proposals expand the kinds of plans to which benefits may be rolled over.

<sup>68</sup> This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

### Effective Date

The proposal would be effective for distributions after December 31, 2001.

#### **4. Strengthening pension security and enforcement**

##### **(a) Phase-in repeal of 160 percent of current liability funding limit; deduction for contributions to fund termination liability**

### Present Law

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)).<sup>69</sup> In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.<sup>70</sup> In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

### Description of Proposal

#### **Current liability full funding limit**

The proposal would gradually increase and then repeal the current liability full funding limit. The current liability full funding limit would be 160 percent of current liability for plan

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<sup>69</sup> The minimum funding requirements, including the full funding limit, are also contained in title I of ERISA.

<sup>70</sup> As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text.

years beginning in 2002, 165 percent for plan years beginning in 2003, and 170 percent for plan years beginning in 2004. The current liability full funding limit would be repealed for plan years beginning in 2005 and thereafter. Thus, in 2005 and thereafter, the full funding limit would be the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

### **Deduction for contributions to fund termination liability**

The special rule allowing a deduction for unfunded current liability generally would be extended to all defined benefit pension plans, i.e., the proposal would apply to multiemployer plans and plans with 100 or fewer participants. The special rule would not apply to plans not covered by the PBGC termination insurance program.<sup>71</sup>

The proposal also would modify the rule by providing that the deduction is for up to 100 percent of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability would not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years.

### **Effective Date**

The proposal would be effective for plan years beginning after December 31, 2001.

### **(b) Excise tax relief for sound pension funding**

#### **Present Law**

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (sec. 412(c)(7)). In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent

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<sup>71</sup> The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

for plan years beginning in 2005 and thereafter.<sup>72</sup> In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

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. The 10-percent excise tax does not apply to contributions to certain terminating defined benefit plans. The 10-percent excise tax also does not apply to contributions of up to 6 percent of compensation to a defined contribution plan for employer matching and employee elective deferrals.

### **Description of Proposal**

In determining the amount of nondeductible contributions, the employer would be permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit would not be subject to the excise tax on nondeductible contributions. An employer making such an election for a year would not be permitted to take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(c) Modifications to section 415 limits for multiemployer plans**

#### **Present Law**

Under present law, limits apply to contributions and benefits under qualified plans (sec. 415). The limits on contributions and benefits under qualified plans are based on the type of plan.

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<sup>72</sup> As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text. Another proposal would gradually increase and then repeal the current liability full funding limit.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of average compensation for the highest three years, or (2) \$140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in \$5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age.

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is \$75,000.

In the case of a defined contribution plan, the limit on annual additions is the lesser of (1) 25 percent of compensation<sup>73</sup> or (2) \$35,000 (for 2001).

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a multiemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.<sup>74</sup>

### **Description of Proposal**

Under the proposal, the 100 percent of compensation defined benefit plan limit would not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, the proposal would provide that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100 percent of compensation limit to such single-employer plan.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

### **(d) Investment of employee contributions in 401(k) plans**

### **Present Law**

The Employee Retirement Income Security Act of 1974, as amended (“ERISA”) prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities

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<sup>73</sup> Another proposal would increase this limit to 100 percent of compensation.

<sup>74</sup> Treas. Reg. sec. 1.415-8(e).

and property exceeds 10 percent of the fair market value of plan assets. The 10 percent limitation does not apply to any “eligible individual account plans” that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement (“401(k) plans”).

The term “eligible individual account plan” does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than 1 percent of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10 percent limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10 percent of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10 percent of the value of the assets of all pension plans maintained by the employer. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

### **Description of Proposal**

The proposal would modify the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

### **Effective Date**

The proposal would be effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

## **(e) Periodic pension benefit statements**

### **Present Law**

Title I of ERISA provides that a pension plan administrator must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. This 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 1 benefit statement during any 12-month period. The plan administrator must furnish the benefit statement no later than 60 days after receipt of the request or, if later, 120 days after the close of the immediately preceding plan year.

In addition, the plan administrator must furnish a benefit statement to each participant whose employment terminates or who has a 1-year break in service. For purposes of this benefit statement requirement, a "1-year break in service" is a calendar year, plan year, or other 12-month period designated by the plan during which the participant does not complete more than 500 hours of service for the employer. A participant is not entitled to receive more than 1 benefit statement with respect to consecutive breaks in service. The plan administrator must provide a benefit statement required upon termination of employment or a break in service no later than 180 days after the end of the plan year in which the termination of employment or break in service occurs.

### **Description of Proposal**

A plan administrator of a defined contribution plan generally would be required to furnish a benefit statement to each participant at least once annually and to a beneficiary upon written request.

In addition to providing a benefit statement to a beneficiary upon written request, the plan administrator of a defined benefit plan generally would be required either (1) to furnish a benefit statement at least once every 3 years to each participant who has a vested accrued benefit and who is employed by the employer at the time the plan administrator furnishes the benefit statements to participants, or (2) to annually furnish written, electronic, telephonic, or other appropriate notice to each participant of the availability of and the manner in which the participant may obtain the benefit statement.

The plan administrator of a multiemployer plan or a multiple employer plan would be required to furnish a benefit statement only upon written request of a participant or beneficiary.<sup>75</sup>

The plan administrator would be required to write the benefit statement in a manner calculated to be understood by the average plan participant and would be permitted to furnish the statement in written, electronic, telephonic, or other appropriate form.

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<sup>75</sup> A multiple employer plan is a plan that is maintained by 2 or more unrelated employers but that is not maintained pursuant to a collective-bargaining agreement (sec. 413(c)).

### **Effective Date**

The proposal would be effective for plan years beginning after December 31, 2001.

### **(f) Prohibited allocations of stock in an S corporation ESOP**

#### **Present Law**

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (sec. 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

#### **Description of Proposal**

##### **In general**

Under the proposal, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person would be treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax would be imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax would be imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.<sup>76</sup>

It is intended that the proposal will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

##### **Definition of nonallocation year**

A nonallocation year would mean any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation.

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<sup>76</sup> The plan would not be disqualified merely because an excise tax is imposed under the provision.

A person would be a disqualified person if the person is either (1) a member of a “deemed 20-percent shareholder group” or (2) a “deemed 10-percent shareholder.” A person would be a member of a “deemed 20-percent shareholder group” if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation.<sup>77</sup> A person would be a deemed 10-percent shareholder if the person is not a member of a deemed 20-percent shareholder group and the number of the person’s deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation.

In general, “deemed-owned shares” would mean: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual’s share of unallocated stock held by the ESOP. An individual’s share of unallocated stock held by an ESOP would be determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether there is a nonallocation year, ownership of stock generally would be attributed under the rules of section 318,<sup>78</sup> except that: (1) the family attribution rules would be modified to include certain other family members, as described below, (2) option attribution would not apply (but instead special rules relating to synthetic equity described below would apply), and (3) “deemed-owned shares” held by the ESOP would be treated as held by the individual with respect to whom they are deemed owned.

Under the proposal, family members of an individual would include (1) the spouse<sup>79</sup> of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual’s spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

The proposal contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based would be treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment would result in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year would include those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

“Synthetic equity” would mean any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock

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<sup>77</sup> A family member of a member of a “deemed 20-percent shareholder group” with deemed owned shares would also be treated as a disqualified person.

<sup>78</sup> These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity.

<sup>79</sup> As under section 318, an individual’s spouse is not treated as a member of the individual’s family if the spouses are legally separated.

of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also would include a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.<sup>80</sup>

Ownership of synthetic equity would be attributed in the same manner as stock would be attributed under the proposal (as described above). In addition, ownership of synthetic equity would be attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

### **Definition of prohibited allocation**

An ESOP of an S corporation would be required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A “prohibited allocation” would refer to violations of this provision. A prohibited allocation would occur, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

### **Application of excise tax**

In the case of a prohibited allocation, the S corporation would be liable for an excise tax equal to 50 percent of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax would equal to 50 percent of the fair market value of such stock.

A special rule would apply in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also would apply to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

As mentioned above, the S corporation also would be liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax would be 50 percent of the value of the shares on which synthetic equity is based.

### **Treasury regulations**

The Treasury Department would be given the authority to prescribe such regulations as may be necessary to carry out the purposes of the proposal.

### **Effective Date**

The proposal generally would be effective with respect to plan years beginning after December 31, 2002. In the case of an ESOP established after July 11, 2000, or an ESOP

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<sup>80</sup> The provisions relating to synthetic equity would not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

established on or before such date if the employer maintaining the plan was not an S corporation on such date, the proposal would be effective with respect to plan years ending after July 11, 2000.

**(g) Automatic rollovers of certain mandatory distributions**

**Present Law**

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 and, if applicable, the participant's spouse, if the present value of the benefit does not exceed \$5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. 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.

**Description of Proposal**

The proposal would make a direct rollover the default option for involuntary cashouts that exceed \$1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution would be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator would be required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator would also be required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

The proposal would amend the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

The proposal would direct the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with the proposal would be deemed to satisfy the requirements of section 404(a) of ERISA. In addition, the proposal would authorize and direct the Secretary of the Treasury and the Secretary of Labor to give consideration to providing special relief with respect to the use of low-cost individual retirement

plans for purposes of the proposal and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes.

### **Effective date**

The proposal would apply to distributions that occur after the Department of Labor has adopted final regulations implementing the proposal.

### **(h) Notice of significant reduction in plan benefit accruals**

#### **Present Law**

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice (“section 204(h) notice”), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order (“QDRO”), and each employee organization representing participants in the plan. The applicable Treasury regulations<sup>81</sup> provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was required to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

The Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

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<sup>81</sup> Treas. Reg. sec. 1.411(d)-6.

## Description of Proposal

The proposal would add to the Internal Revenue Code a requirement that the plan administrator of a defined benefit pension plan furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy.<sup>82</sup> The notice would be required to set forth: (1) a summary of the plan amendment and the effective date of the amendment; (2) a statement that the amendment is expected to significantly reduce the rate of future benefit accrual; (3) a description of the classes of employees reasonably expected to be affected by the reduction in the rate of future benefit accrual; (4) examples illustrating the plan changes for these classes of employees; (5) in the event of an amendment that results in the significant restructuring of the plan benefit formula, as determined under regulations prescribed by the Secretary (a “significant restructuring amendment”), a notice that the plan administrator will provide, generally no later than 15 days prior to the effective date of the amendment, a “benefit estimation tool kit” (described below) that will enable employees who have completed at least 1 year of participation to personalize the illustrative examples; and (6) notice of each affected participant’s right to request, and of the procedures for requesting, an annual benefit statement as provided under present law. The plan administrator would be required to provide the notice not less than 45 days before the effective date of the plan amendment.

The notice requirement would not apply to governmental plans or church plans with respect to which an election to have the qualified plan participation, vesting, and funding rules apply has not been made (sec. 410(d)).

The plan administrator would be required to provide this generalized notice to each affected participant and each affected alternate payee. For purposes of the proposal, an affected participant or alternate payee would be a participant or alternate payee to whom the significant reduction in the rate of future benefit accrual is reasonably expected to apply.

As noted above, the proposal would require the plan administrator to provide a benefit estimation tool kit, no later than 15 days prior to the amendment effective date, to a participant for whom the amendment may reasonably be expected to produce a significant reduction in the rate of future benefit accrual if the amendment is a significant restructuring amendment. The plan administrator would not be required to provide this benefit estimation tool kit to any participant who has less than 1 year of participation in the plan.

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<sup>82</sup> The proposal also would modify the present-law notice requirement contained in section 204(h) of Title I of ERISA to provide that an applicable pension plan may not be amended to provide for a significant reduction in the rate of future benefit accrual in the event of a failure by the plan administrator to exercise due diligence in meeting a notice requirement similar to the notice requirement that the provision adds to the Internal Revenue Code. In addition, the proposal would expand the current ERISA notice requirement regarding significant reductions in normal retirement benefit accrual rates to early retirement benefits, retirement-type subsidies, and ancillary benefits.

The benefit estimation tool kit would be designed to enable participants to estimate benefits under the old and new plan provisions. The proposal would permit the tool kit to be in the form of software (for use at home, at a workplace kiosk, or on a company intranet), worksheets, or calculation instructions, or other formats to be determined by the Secretary of the Treasury. The tool kit would be required to include any necessary actuarial assumptions and formulas and to permit the participant to estimate both a single life annuity at appropriate ages and, when available, a lump sum distribution. The tool kit would be required to disclose the interest rate used to compute a lump sum distribution and whether the value of early retirement benefits is included in the lump sum distribution.

The proposal would require the benefit estimation tool kit to accommodate employee-provided variables with respect to age, years of service, retirement age, covered compensation, and interest rate (when variable rates apply). The tool kit would be required to permit employees to recalculate estimated benefits by changing the values of these variables. The proposal would not require the tool kit to accommodate employee variables with respect to qualified domestic relations orders, factors that result in unusual patterns of credited service (such as extended time away from the job), special benefit formulas for unusual situations, offsets from other plans, and forms of annuity distributions.

In the case of a significant restructuring amendment that occurs in connection with a business disposition or acquisition transaction and within 1 year following the date of the transaction, the proposal would require the plan administrator to provide the benefit estimation tool kit prior to the date that is 12 months after the date on which the generalized notice of the amendment is given to the affected participants.

The proposal would permit a plan administrator to provide any notice required under the proposal to a person designated in writing by the individual to whom it would otherwise be provided. In addition, the proposal would authorize the Secretary of the Treasury to allow any notice required under the proposal to be provided by using new technologies, provided that at least one option for providing notice is not dependent upon new technologies.

The proposal would impose on a plan administrator that fails to comply with the notice requirement an excise tax equal to \$100 per day per omitted participant and alternate payee. No excise tax would be imposed during any period during which any person subject to liability for the tax did not know that the failure existed and exercised reasonable diligence to meet the notice requirement. In addition, no excise tax would be imposed on any failure if any person subject to liability for the tax exercised reasonable diligence to meet the notice requirement and such person provides the required notice during the 30-day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that the failure existed. Also, if the person subject to liability for the excise tax exercised reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year of the employer would not exceed \$500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive relative to the failure involved.

The proposal would direct the Secretary of the Treasury to issue, not later than 1 year after the date of enactment, regulations with respect to early retirement benefits or retirement-

type subsidies, the determination of a significant restructuring amendment, and the examples that would be required under the generalized notice and the benefit estimation tool kit.

In addition, the proposal would direct the Secretary of the Treasury to prepare a report on the effects of significant restructurings of plan benefit formulas of traditional defined benefit plans. Such study would examine the effect of such restructurings on longer service participants, including the incidence and effects of “wear away” provisions under which participants earn no additional benefits for a period of time after the restructuring. The Secretary would be directed to submit such report, together with recommendations thereon, to the Committee on Ways and Means and the Committee on Education and the Workforce of the House of Representatives and the Committee on Finance and the Committee on Health, Education, Labor, and Pensions of the Senate as soon as practicable, but not later than one year after the date of enactment.

### **Effective Date**

The proposal would be effective for plan amendments taking effect on or after the date of enactment. The period for providing any notice required under the proposal would not end before the last day of the 3-month period following the date of enactment. Prior to the issuance of Treasury regulations, a plan would be treated as meeting the requirements of the proposal if the plan makes a good faith effort to comply with such requirements.

## **5. Reducing regulatory burdens**

### **(a) Modification of timing of plan valuations**

#### **Present Law**

Under present law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.<sup>83</sup>

#### **Description of Proposal**

The proposal would incorporate into the statute the proposed regulation regarding the date of valuations. The proposal would also provide, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 125 percent of the plan's current liability. Information determined as of such date would be required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. An election to use a prior plan year valuation date, once made, could only be revoked with the consent of the Secretary.

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<sup>83</sup> Prop. Treas. Reg. sec. 1.412(c)(9)-1(b)(1).

### **Effective Date**

The proposal would be effective for plan years beginning after December 31, 2001.

#### **(b) ESOP dividends may be reinvested without loss of dividend deduction**

### **Present Law**

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (sec. 404(k)(5)).

### **Description of Proposal**

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer would be entitled to deduct the applicable percentage of dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities. The applicable percentage would be 25 percent for 2002 through 2004, 50 percent for 2005 through 2007, 75 percent for 2008 through 2010 and 100 percent for 2011 and thereafter.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001.

#### **(c) Repeal transition rule relating to certain highly compensated employees**

### **Present Law**

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee<sup>84</sup> who (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 \$85,000 (for 2001) or (b) at the election of the

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<sup>84</sup> An employee includes a self-employed individual.

employer, had compensation in excess of \$85,000 for the preceding year and was in the top 20 percent of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements (“section 401(k) plans”) and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

### **Description of Proposal**

The proposal would repeal the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition would apply.

### **Effective Date**

The proposal would be effective for plan years beginning after December 31, 2001.

### **(d) Employees of tax-exempt entities**

#### **Present Law**

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement (“section 401(k) plan”). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the nondiscrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95 percent of the employees who could participate in the section 401(k) plan benefit under the plan for the plan year.<sup>85</sup>

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a “section 403(b) annuity”) that allows employees to make salary reduction contributions.

### **Description of Proposal**

The Treasury Department would be directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no

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<sup>85</sup> Treas. Reg. sec. 1.410(b)-6(g).

employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95 percent of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations would be effective for years beginning after December 31, 1996.

### **Effective Date**

The proposal would be effective on the date of enactment.

### **(e) Treatment of employer-provided retirement advice**

#### **Present Law**

Under present law, certain employer-provided fringe benefits are excludable from gross income (sec. 132) and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment would be allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable.

In addition, if certain requirements are satisfied, up to \$5,250 annually of employer-provided educational assistance is excludable from gross income (sec. 127) and wages. This exclusion expires with respect to courses beginning after December 31, 2001.<sup>86</sup> Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

#### **Description of Proposal**

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan would be excludable from income and wages. The exclusion would 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. The exclusion would be intended to allow employers to provide advice and information regarding retirement planning. The exclusion would not be limited to information regarding the qualified plan, and, thus, for example, would apply 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 would not be intended to apply

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<sup>86</sup> The exclusion does not apply with respect to graduate-level courses.

to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

### **Effective Date**

The proposal would be effective with respect to taxable years beginning after December 31, 2001.

### **(f) Reporting simplification**

#### **Present Law**

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation (“PBGC”). The plan administrator must use the Form 5500 series as the format for the required annual return.<sup>87</sup> The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

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

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

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<sup>87</sup> Treas. Reg. sec. 301.6058-1(a).

## **Description of Proposal**

The Secretary of the Treasury would be directed to modify the annual return filing requirements with respect to plans that satisfy the eligibility requirements for Form 5500-EZ to provide that if the total value of the plan assets of such a plan as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed \$250,000, the plan administrator is not required to file a return.

## **Effective Date**

The proposal would be effective on January 1, 2002.

## **(g) Improvement to Employee Plans Compliance Resolution System**

### **Present Law**

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

The Internal Revenue Service (“IRS”) has established the Employee Plans Compliance Resolution System (“EPCRS”), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), as applicable.<sup>88</sup> 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

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<sup>88</sup> Rev. Proc. 2001-17, 2001-7 I.R.B. 589.

reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

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

### **Description of Proposal**

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

### **Effective Date**

The proposal would be effective on the date of enactment.

### **(h) Repeal of the multiple use test**

### **Present Law**

Elective deferrals under a qualified cash or deferred arrangement (“section 401(k) plan”) are subject to a special annual nondiscrimination test (“ADP test”). The ADP test compares the actual deferral percentages (“ADPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee’s deferral percentage generally is the employee’s elective deferrals for the year divided by the employee’s compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also are subject to a special annual nondiscrimination test (“ACP test”). The ACP test compares the actual deferral percentages (“ACPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an

allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than 2 percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer's plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125 percent of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125 percent of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test ("multiple use test") applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) 2 percentage points plus (but not more than 2 times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) 2 percentage points plus (but not more than 2 times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

### **Description of Proposal**

The proposal would repeal the multiple use test.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

#### **(i) Flexibility in nondiscrimination, coverage, and line of business rules**

### **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.

### **Description of Proposal**

The Secretary of the Treasury would be directed to modify, on or before December 31, 2001, 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 would be directed to provide by regulation applicable to years beginning after December 31, 2001, that a plan is deemed to satisfy the nondiscrimination requirements of section 401(a)(4) if the plan satisfies the pre-1994 facts and circumstances test, satisfies 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 would comply with the minimum coverage requirement of section 410(b) if the plan satisfies the pre-1989 coverage rules, is submitted to the Secretary for a determination of whether it satisfies 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 proposal relating to the line of business requirements under section 414(r) would be effective on the date of enactment. The proposal relating to the nondiscrimination requirements under section 401(a)(4) would be effective on the date of enactment, except that any condition of availability prescribed by the Secretary would not be effective before the first year beginning not less than 120 days after the date on which such condition is prescribed. The proposal relating to the minimum coverage requirements under section 410(b) would be effective for years beginning after December 31, 2001, except that any condition of availability prescribed by the Secretary by regulation would not apply before the first year beginning not less than 120 days after the date on which such condition is prescribed.

**(j) Extension to all governmental plans of moratorium on application of certain nondiscrimination rules applicable to State and local government plans**

**Present Law**

A qualified retirement plan maintained by a State or local government is exempt from the 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.

**Description of Proposal**

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

**Effective Date**

The proposal would be effective for plan years beginning after December 31, 2001.

**(k) Notice and consent period regarding distributions; disclosure of optional forms of benefits**

**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.<sup>89</sup>

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.

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<sup>89</sup> Similar provisions are contained in Title I of ERISA.

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.

The plan administrator is required to provide to the distributee of an eligible rollover distribution an explanation of the rollover and withholding rules applicable to the distribution. This notice must generally be provided no less than 30 days and not more than 90 days before the date of the distribution.

### **Description of Proposal**

A qualified retirement plan would be 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 would be 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 addition, the proposal would require that plan participants be notified of the existence of certain differences between the values of optional forms of benefit. If a plan provides optional forms of benefits and the present values of such optional forms of benefits are not actuarially equivalent as of the annuity starting date, then the plan would be required to provide certain information regarding such benefits in the notice required to be provided regarding joint and survivor annuities. The information would be required to be sufficient (as determined in accordance with Treasury regulations) to allow the participant to understand the differences in the present values of the optional forms of benefits and the effect the participant's election as to the form of benefit would have on the value of the benefits provided under the plan. The information would be required to be provided in a manner calculated to be reasonably understood by the average plan participant.

### **Effective Date**

The proposal would be effective for years beginning after December 31, 2001.

#### **(I) Annual report dissemination**

### **Present Law**

Title I of ERISA generally requires the plan administrator of each employee pension benefit plan and each employee welfare benefit plan to file an annual report concerning the plan with the Secretary of Labor within seven months after the end of the plan year. Within nine months after the end of the plan year, the plan administrator generally must provide to each participant and to each beneficiary receiving benefits under the plan a summary of the annual report filed with the Secretary of Labor for the plan year.

### **Description of Proposal**

Within nine months after the end of each plan year, the plan administrator would be required to make available for examination a summary of the annual report filed with the Secretary of Labor for the plan year. In addition, the plan administrator would be required to furnish the summary to a participant, or to a beneficiary receiving benefits under the plan, upon request.

### **Effective Date**

The proposal would be effective for reports for years beginning after December 31, 2000.

### **(m) Amendments to SAVER Act**

#### **Present Law**

The Savings Are Vital to Everyone's Retirement ("SAVER") Act<sup>90</sup> initiated a public-private partnership to educate American workers about retirement savings and directed the Department of Labor to maintain an ongoing program of public information and outreach. The Act also convened a National Summit on Retirement Savings held June 4-5 1998, and to be held again in 2001 and 2005, co-hosted by the President and the bipartisan Congressional leadership. The National Summit brings together experts in the fields of employee benefits and retirement savings, key leaders of government, and interested parties from the private sector and general public. The delegates are selected by the Congressional leadership and the President. The National Summit is a public-private partnership, receiving substantial funding from private sector contributions. The National Summits' goals are to: (1) advance the public's knowledge and understanding of retirement savings and facilitate the development of a broad-based, public education program; (2) identify the barriers which hinder workers from setting aside adequate savings for retirement and impede employers, especially small employers, from assisting their workers in accumulating retirement savings; and (3) develop specific recommendations for legislative, executive, and private sector actions to promote retirement income savings among American workers.

### **Description of Proposal**

The proposal would make amendments to the SAVER Act regarding the administration of future statutorily created National Summits on Retirement Savings. It would clarify that such National Summits are to be held in the month of September in 2001 and 2005, and would add an additional National Summit in 2009. To facilitate the administration of future National Summits, the Department of Labor would be given authority to enter into cooperative agreements (pursuant to the Federal Grant and Cooperative Agreement Act of 1977) with its 1999 summit partner, the American Savings Education Council.

Six new statutory delegates would be added to future National Summits: the Chairman and Ranking Member of the House Ways and Means Committee, the Senate Finance Committee,

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<sup>90</sup> Pub. L. No. 105-92.

and the Subcommittee on Employer-Employee Relations of the House Committee on Education and the Workforce. Further, the President, in consultation with the Congressional leadership, could appoint up to three percent of the delegates (not to exceed 10) from a list of nominees provided by the private sector partner in Summit administration. The proposal would also clarify that new delegates are to be appointed for each future National Summit (as was the intent of the original legislation) and would set deadlines for their appointment.

The proposal would also set deadlines for the Department of Labor to publish the Summit agenda, give the Department of Labor limited reception and representation authority, and mandate that the Department of Labor consult with the Congressional leadership in drafting the post-Summit report.

#### **Effective Date**

The proposal would be effective on the date of enactment.

#### **(n) Studies**

#### **Present Law**

No provision.

#### **Description of Proposal**

##### **Report on pension coverage**

The proposal would direct the Secretary of the Treasury to report to the House Committee on Ways and Means and the Senate Committee on Finance regarding the effect of the proposal on pension coverage, including any expansion of coverage for low- and middle-income workers, levels of pension benefits, quality of coverage, worker's access to and participation in plans, and retirement security. This report would be required to be submitted no later than five years after the date of enactment.

##### **Study of preretirement use of benefits and investment decisions**

The proposal would direct the Secretary of the Treasury to conduct a study of the present-law rules that permit individuals to access their IRA or qualified retirement plan benefits prior to retirement, including an analysis of the use of the existing rules and the extent to which such rules undermine the goal of accumulating adequate resources for retirement. In addition, the study would consider the types of investment decisions made by IRA owners and participants in self-directed qualified retirement plans, including an analysis of the existing restrictions on investments and the extent to which additional restrictions would facilitate the accumulation of adequate income for retirement. The study and any recommendations are required to be submitted to the House Committee on Ways and Means and the Senate Committee on Finance no later than January 1, 2003.

### **Effective Date**

The proposal would be effective on the date of enactment.

## **6. Other ERISA provisions**

### **(a) Extension of PBGC missing participants program**

#### **Present Law**

The plan administrator of a defined benefit pension plan that is subject to Title IV of ERISA, is maintained by a single employer, and terminates under a standard termination is required to distribute the assets of the plan. With respect to a participant whom the plan administrator of a single employer plan cannot locate after a diligent search, the plan administrator satisfies the distribution requirement only by purchasing irrevocable commitments from an insurer to provide all benefit liabilities under the plan 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.

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

#### **Description of Proposal**

The proposal would direct the PBGC to prescribe for terminating multiemployer plans rules 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 would be permitted, but not required, to elect to transfer missing participants' benefits to the PBGC upon plan termination. Specifically, the proposal would extend the missing participants program to defined contribution plans, defined benefit plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

#### **Effective Date**

The proposal would be effective for distributions from terminating plans that occur after the PBGC has adopted final regulations implementing the proposal.

## **(b) Reduce PBGC premiums for small and new plans**

### **Present Law**

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

The PBGC guarantee is phased-in ratably in the case of plans that have been in effect for less than 5 years, and with respect to benefit increases from a plan amendment that was in effect for less than 5 years before termination of the plan.

### **Description of Proposal**

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

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

A small employer is 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 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 taken into account in determining whether the plan is 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 are in the new plan.

#### **Reduced variable-rate PBGC premium for new plans**

The proposal would provide 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 would be a percentage of the variable premium otherwise due, as follows: 0 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 proposal relating to new small employer plans.

### **Reduced variable-rate PBGC premium for small plans**

In the case of a plan of a small employer, the variable-rate premium would be no more than \$5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For purposes of the proposal, a small employer is a contributing sponsor that, on the first day of the plan year, has 25 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are 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 taken into account in determining whether the plan is 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 would be effective with respect to plans established after December 31, 2001. The reduction of the variable-rate premium for small plans would be effective with respect to plan years beginning after December 31, 2001.

### **(c) Authorization for PBGC to pay interest on premium overpayment refunds**

#### **Present Law**

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

#### **Description of Proposal**

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

#### **Effective Date**

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

### **(d) Rules for substantial owner benefits in terminated plans**

#### **Present Law**

Under present law, the Pension Benefit Guaranty Corporation (“PBGC”) provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees

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

### **Description of Proposal**

The proposal would provide that the 60-month phase-in of guaranteed benefits would apply 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 would depend on the number of years the plan has been in effect. The majority owner's guaranteed benefit would be limited so that it could not be more than the amount phased-in over 60 months for other participants. The rules regarding allocation of assets would apply to substantial owners, other than majority owners, in the same manner as other participants.

### **Effective Date**

The proposal would be 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, 2001.

### **(e) Civil penalties for breach of fiduciary responsibility**

#### **Present Law**

Present law requires the Secretary of Labor to assess a civil penalty against (1) a fiduciary who breaches a fiduciary responsibility under, or commits a violation of, part 4 of Title I of ERISA, or (2) any other person who knowingly participates in such a breach or violation. The penalty is equal to 20 percent of the "applicable recovery amount" that is paid pursuant to a settlement agreement with the Secretary of Labor or that a court orders to be paid in a judicial proceeding brought by the Secretary of Labor to enforce ERISA's fiduciary responsibility provisions. The Secretary of Labor may waive or reduce the penalty only if the Secretary finds in writing that either (1) the fiduciary or other person acted reasonably and in good faith, or (2) it is reasonable to expect that the fiduciary or other person cannot restore all the losses without severe financial hardship unless the waiver or reduction is granted.

## **Description of Proposal**

The proposal would make the assessment of the penalty discretionary with the Secretary of Labor, rather than mandatory. This change would allow the Secretary to refrain from imposing the penalty in certain cases as well as to assess a penalty of less than 20 percent of the applicable recovery amount. The requirement of a settlement agreement would also be eliminated. The applicable recovery amount would be any amount recovered by a plan or by a participant or beneficiary more than 30 days after the fiduciary's or other person's receipt of a written notice of the violation from the Department of Labor ("DOL"). Payments made after the 30-day grace period<sup>91</sup>, whether they are made pursuant to a settlement agreement, or simply to discourage the DOL from bringing a legal action, would be subject to the penalty, as are amounts recovered pursuant to a court order. ERISA section 502(l) would also be amended to clarify that the term "applicable recovery amount" includes payments by third parties that are made on behalf of the relevant fiduciary or other persons liable for the amount that is recovered, including those who did not actually pay. These changes would prevent avoidance of the penalty by having an unrelated third party pay the recovery amount.

## **Effective Date**

The proposal would apply to any breach of fiduciary responsibility or other violation of part 4 of Title I of ERISA occurring on or after the date of enactment. The change with respect to "applicable recovery amount" would include a transition rule whereby a breach or other violation occurring before the date of enactment which continues past the 180th day from enactment (and which may have been discontinued during that period) would be treated as having occurred after the date of enactment (to avoid having to make a complex determination regarding how much of the applicable recovery amount for such continuing violations should be attributed to the post-enactment part of the violation).

### **(f) Benefit suspension notice**

## **Present Law**

Under present law (ERISA sec. 203(a)(3)(B)), a plan will not fail to satisfy the vesting requirements with respect to a participant by reason of suspending payment of the participant's benefits while such participant is employed. Under the applicable Department of Labor ("DOL") regulations, such a suspension is only permissible if the plan notifies the participant during the first calendar month or payroll period in which the plan withholds benefit payments. Such notice must provide certain information and must also include a copy of the plan's provisions relating to the suspension of payments.

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

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<sup>91</sup> The Secretary of Labor would be permitted to extend the 30-day period.

### **Description of Proposal**

The proposal would direct the Secretary of Labor to revise the regulations relating to the benefit suspension notice to generally permit the information currently required to be set forth in a suspension notice to be included in the summary plan description. The proposal also would direct the Secretary of Labor to eliminate the requirement that the notice include a copy of relevant plan provisions. However, individuals reentering the workforce to resume work with a former employer after they have begun to receive benefits would still receive the notification of the suspension of benefits (and a copy of the plan's provisions relating to suspension of payments). In addition, if a reduced rate of future benefit accruals would apply to a returning employee (as of his or her first date of participation in the plan after returning to work) who has begun to receive benefits, the notice would be required to include a statement that the rate of future benefit accruals will be reduced.

### **Effective Date**

The proposal would apply to plan years beginning after December 31, 2001.

## **7. Miscellaneous provisions**

### **(a) Preservation of pension plans**

#### **Present Law**

Eligibility for needs-tested public benefits, such as supplemental security income or food stamps, is determined by reference to the assets of the applicant (and family members) as well as income. Assets that are accessible to the applicant (or family members) are taken into account while assets that are not accessible are not. In addition, some assets are specifically excluded in means testing, such as a personal residence or a car. Present law does not provide a specific exclusion for retirement savings.

### **Description of Proposal**

Under the proposal, any program that requires consideration of the financial circumstances of an individual or household for the purpose of determining eligibility to receive, or the amount of, any assistance or benefit authorized to be provided to or for the benefit of such individual or household, benefits to which the individual is or may become entitled, including any balances credited to the individual's account and any other accrued benefits, under a qualifying retirement plan would be disregarded for such purpose. For purposes of the proposal, a qualifying retirement plan would be a qualified retirement plan or annuity, section 403(b) annuity, an IRA, an eligible deferred compensation plan under section 457(b), or a trust described in section 501(c)(18). The proposal would not apply to funds that have been distributed from a qualifying retirement plan.

### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2001.

## **(b) Tax treatment of Alaska Native Settlement Trusts**

### **Present Law**

An Alaska Native Settlement Corporation ("ANC") may establish a Settlement Trust ("Trust") under section 39 of the Alaska Native Claims Settlement Act ("ANCSA")<sup>92</sup> and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code. The Trust and its beneficiaries are taxed in accordance with trust rules.

### **Description of Proposal**

The proposal would provide for an election under which an ANC could transfer property to an electing Trust without tax to the beneficiaries. The electing Trust would pay tax on its income at the lowest rate specified for ordinary income of an individual (or lower capital gains rate). The proposal also would specify the treatment of distributions by an electing Trust to beneficiaries, the reporting requirements associated with such an election, and the consequences of disqualification for these benefits due to the allowance of certain impermissible dispositions of Trust interests or ANC stock.

Under the proposal, an Alaska Native Corporation would be permitted to establish a Trust under section 39 of ANCSA, and if the Trust made an election for its first taxable year ending after the date of enactment of the proposal, no amount would be included in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust.<sup>93</sup> In addition, unless the electing Trust failed to meet the transferability requirements of the provision, income of the Trust, whether accumulated or distributed, would be taxed only to the Trust (and not to beneficiaries) at the lowest individual tax rate for ordinary income (and the capital gains rate applicable to individuals subject to such rate), rather than at the higher rates generally applicable to trusts or to higher tax bracket beneficiaries.

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<sup>92</sup> 43 U.S.C. 1601 et. seq.

<sup>93</sup> If the ANC transfers appreciated property to the Trust, section 311(b) of the Code would apply to the ANC, so that the ANC would recognize gain as if it had sold the property for fair market value. The Trust then would take that property with a fair market value basis, pursuant to section 301(d) of the Code.

The treatment to beneficiaries of amounts distributed by an electing Trust would depend upon the amount of the distribution. Solely for purposes of determining what amount has been distributed and thus which treatment applies under these rules, the amount of any distribution of property would be the fair market value of the property at the time of the distribution.<sup>94</sup>

Amounts distributed by an electing Trust during any taxable year would be excludable from the gross income of the recipient beneficiary to the extent of the taxable income of the Trust for the taxable year and all prior taxable years for which an election was in effect (decreased by any income tax paid by the Trust with respect to the income) plus any amounts excluded from gross income of the Trust under section 103 for those periods.<sup>95</sup>

If distributions to beneficiaries exceed the excludable amounts described above, then such excess distributions would be reported and taxed to beneficiaries as if distributed by the ANC in the year of the distribution by the electing Trust to the extent the ANC then has current or accumulated earnings and profits, and would be treated as dividends to beneficiaries.<sup>96</sup> Additional distributions in excess of the current and accumulated earnings and profits of the ANC would be treated by the beneficiaries as distributions by the Trust in excess of the distributable net income of the Trust for such year.<sup>97</sup>

The fiduciary of an electing Trust would be required to report to the IRS, with the Trust tax return, the amount of distributions to each beneficiary, and the tax treatment to the

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<sup>94</sup> Section 661 of the Code, which provides a deduction to the trust for certain distributions, would not apply to an electing Trust under the provision unless the election is terminated by disqualification. Similarly, the inclusion provisions of section 662 of the Code, relating to amounts to be included in income of beneficiaries, also would not apply to a qualified electing Trust.

<sup>95</sup> In the case of any such excludable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary would generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary would be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

<sup>96</sup> The treatment of such amounts distributed by an electing Trust as dividends would apply even if all or any part of the contributions by an ANC to a Trust would not have been dividends at the time of the contribution under present law; for example, because the ANC had no current or accumulated earnings and profits, or because the contribution was made from Alaska Native Fund amounts that may not have been taxable. See 43 U.S.C. 1605.

<sup>97</sup> Such distributions would not be taxable to the beneficiaries. In the case of any such nontaxable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary would generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary would be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

beneficiary of such distributions under the provision (either as exempt from tax to the beneficiary, or as a distribution deemed made by the ANC). The electing Trust would also be required to furnish such information to the ANC. In the case of distributions treated as if made by the ANC, the ANC would then report such amounts to the beneficiaries and would be required to indicate whether they are dividends or not, in accordance with the earnings and profits of the ANC. The reporting thus required by an electing Trust would be in lieu of, and would satisfy, the reporting requirements of section 6034A (and such other reporting requirements as the Secretary of the Treasury may deem appropriate).

The earnings and profits of an ANC would not be reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the ANC earnings and profits would be reduced as and when distributions are thereafter made by the electing Trust that are taxed to beneficiaries under the provision as dividends from the ANC to the Trust beneficiaries.

If the beneficial interests in the electing Trust or the shares of the ANC may be disposed of to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native), then the special provisions applicable to electing Trusts, including the favorable ordinary income tax rate and corresponding lower capital gains tax rate, would cease to apply as of the beginning of such taxable year. The distributable net income of the Trust would be increased up to the amount of current and accumulated earnings and profits of the ANC as of the end of that year, but such increase would not exceed the fair market value of the assets of the Trust as of the date the beneficial interest of the Trust or shares of the ANC became disposable.<sup>98</sup> Thereafter, the Trust and its beneficiaries would generally be subject to the rules of subchapter J and to the generally applicable trust income tax rates. Thus, the increase in distributable net income would result in the Trust being taxed at regular trust rates to the extent the recomputed distributable net income is not distributed to beneficiaries; and beneficiaries would be taxed to the extent there are distributions. Normal reporting rules applicable to trusts and their beneficiaries would apply. The basis of any property distributed to beneficiaries would also be determined under normal trust rules.

The proposal would contain a special loss disallowance rule that would reduce any loss that would otherwise be recognized by a shareholder upon the disposition of a share of stock of a sponsoring ANC by a “per share loss adjustment factor”. This factor would reflect the aggregate of all contributions to an electing Trust sponsored by such ANC made on or after the first day the trust is treated as an electing Trust, expressed on a per share basis and determined as of the day of each such contribution.

The special loss disallowance rule would be intended to prevent the allowance of noneconomic losses if the ANC stock owned by beneficiaries ever becomes transferable in any type of transaction that could cause the recognition of taxable gain or loss, (including a

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<sup>98</sup> To the extent the earnings and profits of the ANC increase distributable net income of the Trust under this provision, the ANC would have a corresponding adjustment reducing its earnings and profits.

redemption by the ANC) where the basis of the stock in the hands of the beneficiary (or in the hands of any transferee of a beneficiary) fails to reflect the allocable reduction in corporate value attributable to amounts transferred by the ANC into the Trust.

#### **Effective date**

The proposal would be effective for taxable years of Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations ending after the date of enactment, and to contributions made to electing Settlement Trusts during such year and thereafter.

### **8. Provisions relating to plan amendments**

#### **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.

#### **Description of Proposal**

Any amendments to a plan or annuity contract required to be made by the proposal would not be required to be made before the last day of the first plan year beginning on or after January 1, 2005. In the case of a governmental plan, the date for amendments would be extended to the last day of the first plan year beginning on or after January 1, 2007. The delayed amendment date would not apply to any amendment required or permitted by the proposal unless, during the period beginning on the date the applicable section of the proposal takes effect and ending on the delayed amendment date, (1) the plan or annuity contract is operated as if such amendment were in effect, and (2) such amendment applies retroactively for such period.

#### **Effective Date**

The proposal would be effective on the date of enactment.

## **VII. INDIVIDUAL ALTERNATIVE MINIMUM TAX RELIEF**

### **A. Individual Alternative Minimum Tax Relief**

#### **Present Law**

Present law imposes an alternative minimum tax on individuals to the extent that the tentative minimum tax exceeds the regular tax. An individual's tentative minimum tax generally is an amount equal to the sum of (1) 26 percent of the first \$175,000 (\$87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income in excess of an exemption amount and (2) 28 percent of the remaining alternative minimum taxable income. Alternative minimum taxable income is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The alternative minimum tax exemption amounts are: (1) \$45,000 in the case of married individuals filing a joint return and surviving spouses; (2) \$33,750 in the case of other unmarried individuals; and (3) \$22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased-out by an amount equal to 25 percent of the amount by which the individual's alternative minimum taxable income exceeds (1) \$150,000 in the case of married individuals filing a joint return and surviving spouses, (2) \$112,500 in the case of other unmarried individuals, and (3) \$75,000 in the case of married individuals filing separate returns or an estate or a trust. The exemption amounts, threshold phase-out amounts, and rate brackets are not indexed for inflation.

#### **Description of Proposal**

The proposal would increase the alternative minimum tax exemption amount for married couples filing a joint return and surviving spouses by \$4,000 in 2001 through 2006. The alternative minimum tax exemption amounts for other individuals (i.e., unmarried individuals and married individuals filing a separate return) would increase by \$2,000 in 2001 through 2006.

#### **Effective Date**

The proposal would be effective for taxable years beginning after December 31, 2000, and before January 1, 2007.