DESCRIPTION OF THE CHAIRMAN'S AMENDMENT IN THE NATURE OF A SUBSTITUTE TO H.R. 2830, THE "PENSION PROTECTION ACT OF 2005"

Scheduled for Markup
By the
COMMITTEE ON WAYS AND MEANS
on November 9, 2005

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the Staff of the
JOINT COMMITTEE ON TAXATION

November 8, 2005
JCX-73-05

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INTRODUCTION

The Committee on Ways and Means has scheduled a markup on November 9, 2005, of H.R. 2830, the "Pension Protection Act of 2005." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's Amendment in the Nature of a Substitute to H.R. 2830.[2]

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Amendment in the Nature of a Substitute to H.R. 2830, the "Pension Protection Act of 2005"* (JCX-73-05), November 8, 2005.

[2] H.R. 2830 was referred to the Committee on Education and the Workforce and the Committee on Ways and Means. The Committee on Education and the Workforce reported the bill on September 22, 2005. See H.R. Rep. No. 109-232, Part I, for provisions included in the bill as reported by Committee on Education and the Workforce.

I. REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS

A. Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans

Present Law

In general

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Employee Retirement Income Security Act of 1974 ("ERISA") and the Internal Revenue Code (the "Code").[3] The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year's portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No contribution is required under the minimum funding rules in excess of the full funding limit (described below).

General minimum funding rules

Funding standard account

As an administrative aid in the application of the funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments, experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an

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[3] Code sec. 412; ERISA secs. 301-308. The minimum funding rules also apply to multiemployer plans, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. The rules for multiemployer plans are discussed in Part II of this document. The minimum funding rules do not apply to governmental plans or to church plans, except church plans with respect to which an election has been made to have various ERISA and Code requirements, including the funding requirements, apply to the plan. In addition, special rules apply to certain plans funded exclusively by the purchase of individual insurance contracts (referred to as "insurance contract" plans).

experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. The gain or loss for a year from changes in actuarial assumptions is amortized as credits or charges to the funding standard account over ten years.

If minimum required contributions are waived (as discussed below), the waived amount (referred to as a "waived funding deficiency") is credited to the funding standard account. The waived funding deficiency is then amortized over a period of five years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded.

If, as of the close of a plan year, the funding standard account reflects credits at least equal to charges, the plan is generally treated as meeting the minimum funding standard for the year. If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the funding standard account would exceed credits to the account if no contribution were made to the plan. For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency.

Credit balances

If credits to the funding standard account exceed charges, a "credit balance" results. A credit balance results, for example, if contributions in excess of minimum required contributions are made. Similarly, a credit balance may result from large net experience gains. The amount of the credit balance, increased with interest at the rate used under the plan to determine costs, can be used to reduce future required contributions.

Funding methods and general concepts

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled. The normal cost will be funded by future contributions to the plan: (1) in level dollar amounts; (2) as a uniform percentage of payroll; (3) as a uniform amount per unit of service (e.g., $1 per hour); or (4) on the basis of the actuarial present values of benefits considered accruing in particular plan years.

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source. For example, the cost attributable to a past service liability is generally amortized over 30 years.

Normal costs and supplemental costs under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. An actuarial valuation is generally required annually and is made as of a date within the plan year or within one month before the beginning of the plan year. However, a valuation date within the preceding plan year may be used if, as of that date, the value of the plan's assets is at least 100 percent of the plan's current liability (i.e., the present value of benefit liabilities under the plan, as described below).

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined under a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.[4]

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[4] Under present law, certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

Additional contributions for underfunded plans

In general

Under special funding rules (referred to as the "deficit reduction contribution" rules),[5] an additional charge to a plan's funding standard account is generally required for a plan year if the plan's funded current liability percentage for the plan year is less than 90 percent.[6] A plan's "funded current liability percentage" is generally the actuarial value of plan assets as a percentage of the plan's current liability.[7] In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan, determined on a present-value basis.

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

The deficit reduction contribution is the sum of (1) the "unfunded old liability amount," (2) the "unfunded new liability amount," and (3) the expected increase in current liability due to benefits accruing during the plan year.[8] The "unfunded old liability amount" is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The "unfunded new liability amount" is the applicable percentage of the plan's unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan's current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan's unfunded old liability and

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[5] The deficit reduction contribution rules apply to single-employer plans, other than single-employer plans with no more than 100 participants on any day in the preceding plan year. Single-employer plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under these rules.

[6] Under an alternative test, a plan is not subject to the deficit reduction contribution rules for a plan year if (1) the plan's funded current liability percentage for the plan year is at least 80 percent, and (2) the plan's funded current liability percentage was at least 90 percent for each of the two immediately preceding plan years or each of the second and third immediately preceding plan years.

[7] In determining a plan's funded current liability percentage for a plan year, the value of the plan's assets is generally reduced by the amount of any credit balance under the plan's funding standard account. However, this reduction does not apply in determining the plan's funded current liability percentage for purposes of whether an additional charge is required under the deficit reduction contribution rules.

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

unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan's funded current liability percentage exceeds 60 percent. For example, if a plan's funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).[9]

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. The value of any unpredictable contingent event benefit is not considered in determining additional contributions until the event has occurred. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

<u>Required interest rate and mortality table</u>

Specific interest rate and mortality assumptions must be used in determining a plan's current liability for purposes of the special funding rule. For plans years beginning before January 1, 2004, the interest rate used to determine a plan's current liability must be within a permissible range of the weighted average[10] of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins. The permissible range is generally from 90 percent to 105 percent (120 percent for plan years beginning in 2002 or 2003).[11] The interest rate used under the plan generally must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan.[12]

Under the Pension Funding Equity Act of 2004 ("PFEA 2004"),[13] a special interest rate applies in determining current liability for plan years beginning in 2004 or 2005.[14] For these

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[9] In making these computations, the value of the plan's assets is reduced by the amount of any credit balance under the plan's funding standard account.

[10] The weighting used for this purpose is 40 percent, 30 percent, 20 percent and 10 percent, starting with the most recent year in the four-year period. Notice 88-73, 1988-2 C.B. 383.

[11] If the Secretary of the Treasury determines that the lowest permissible interest rate in this range is unreasonably high, the Secretary may prescribe a lower rate, but not less than 80 percent of the weighted average of the 30-year Treasury rate.

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

[13] Pub. L. No. 108-218 (2004).

[14] In addition, under PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules apply for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers

years, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. The interest rate is to be determined by the Secretary of the Treasury on the basis of two or more indices that are selected periodically by the Secretary and are in the top three quality levels available.

The Secretary of the Treasury is required to prescribe mortality tables and to periodically review (at least every five years) and update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.[15] The Secretary of the Treasury has required the use of the 1983 Group Annuity Mortality Table.[16]

Other rules

Full funding limitation

No contributions are required under the minimum funding rules in excess of the full funding limitation. The full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.[17] However, the full funding limitation may not be less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

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primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

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

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

[17] For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a percentage (170 percent for 2003) of the plan's current liability (including the current liability normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets, but in no case less than the excess, if any, of 90 percent of the plan's current liability over the actuarial value of plan assets. Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the full funding limitation based on 170 percent of current liability is repealed for plan years beginning in 2004 and thereafter. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

Timing of plan contributions

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

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.[18] The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[19]

Funding waivers

Within limits, the Secretary of the Treasury is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year (a "waived funding deficiency").[20] A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Failure to make required contributions

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[21] The excise tax is 10 percent of the amount of the funding deficiency. In addition, a tax of 100 percent may be imposed if the funding deficiency is not corrected within a certain period.

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

[19] If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall").

[20] Code sec. 412(d); ERISA sec. 303. Under similar rules, the amortization period applicable to an unfunded past service liability or loss may also be extended.

[21] Code sec. 4971. An excise tax applies also if a quarterly installment is less than the amount required to cover the plan's liquidity shortfall.

If the total of the contributions the employer fails to make (plus interest) exceeds $1 million and the plan's funded current liability percentage is less than 100 percent, a lien arises in favor of the plan with respect to all property of the employer and the members of the employer's controlled group. The amount of the lien is the total amount of the missed contributions (plus interest).

Description of Proposal

Interest rate required for plan years beginning in 2006

For plan years beginning after December 31, 2005, and before January 1, 2007, the proposal applies the present-law funding rules, with an extension of the interest rate applicable in determining current liability for plan years beginning in 2004 and 2005. Thus, in determining current liability for funding purposes for plan years beginning in 2006, the interest rate used must be within the permissible range (90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins.

Funding rules for plan years beginning after 2006 - in general

For plan years beginning after December 31, 2006, in the case of single-employer defined benefit plans, the proposal repeals the present-law funding rules (including the requirement that a funding standard account be maintained) and provides a new set of rules for determining minimum required contributions.[22] Under the proposal, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. As described in more detail below, under the proposal, credit balances generated under present law are carried over (into the "funding standard carryover balance") and generally may be used in certain circumstances to reduce otherwise required minimum contributions. In addition, as described more fully below, contributions in excess of the minimum contributions required under the proposal generally are credited to a prefunding balance that may be used in certain circumstances to reduce otherwise required minimum contributions. To facilitate the use of such balances to reduce minimum required contributions, while avoiding use of such balances for more than one purpose, in some circumstances the value of plan assets is reduced by the prefunding balance and/or the funding standard carryover balance.

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[22] The proposal does not change the funding rules applicable to insurance contract plans. Proposed changes to the funding rules for multiemployer plans are discussed in Part II below. Governmental plans and church plans continue to be exempt from the funding rules to the extent provided under present law.

The minimum required contribution for a plan year, based on the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) compared to the funding target, is shown in the following table:

If:	***The minimum required contribution is:***
the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) is less than the funding target,	the sum of: (1) target normal cost; (2) any shortfall amortization charge; and (3) any waiver amortization charge.
the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) exceeds the funding target,	the target normal cost, reduced by the excess of (1) the value of plan assets (reduced by any prefunding balance and funding standard carryover balance), over (2) the funding target.
the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) equals the funding target,	the target normal cost.

Under the proposal, a plan's funding target is the present value of all liabilities under the plan attributable to benefits accrued or earned as of the beginning of the plan year. A plan's target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. A shortfall amortization charge is the amount required to amortize a funding shortfall. In general, a plan has a funding shortfall for a plan year if the plan's funding target for the year exceeds the value of the plan's assets (reduced by any prefunding balance and funding standard carryover balance). A waiver amortization charge is the amount required to amortize a waiver funding deficiency.

The proposal specifies the interest rates and mortality table that must be used in determining a plan's target normal cost and funding target, as well as certain other actuarial assumptions, including special assumptions if the value of a plan's assets (reduced by any prefunding and funding standard carryover balances) for the preceding year was less than 60 percent of the plan's funding target (an "at-risk" plan).

Target normal cost

Under the proposal, the minimum required contribution for a plan year generally includes the plan's target normal cost for the plan year. A plan's target normal cost is the present value of all benefits expected to accrue or be earned under the plan during the plan year (the "current" year). For this purpose, an increase in any benefit attributable to services performed in a preceding year by reason of a compensation increase during the current year is treated as having accrued during the current year.

If the value of a plan's assets (reduced by any funding standard carryover balance and prefunding balance) exceeds the plan's funding target for a plan year, for purposes of determining the minimum required contribution for the plan year, normal cost is reduced by the excess.

Funding target and shortfall amortization charges

In general

If the value of a plan's assets (reduced by any prefunding balance if the employer elects to use the prefunding balance to reduce required contributions for the year) is less than the plan's funding target for a plan year, the minimum required contribution is increased by a shortfall amortization charge. As discussed more fully below, the shortfall amortization charge is the aggregate of the annual installments for the plan year with respect to any shortfall amortization bases for the plan year and the six preceding plan years.

Funding target

A plan's funding target for a plan year is the present value of all liabilities to participants and their beneficiaries under the plan for the plan year. For this purpose, liabilities are taken into account to the extent attributable to benefits (including any early retirement or similar benefits) accrued or earned as of the beginning of the plan year. Benefits accruing in the plan year are not taken into account, irrespective of whether the valuation date for the plan year is later than the first day of the plan year.[23]

Shortfall amortization charge

The shortfall amortization charge for a plan year is the aggregate of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for that plan year and the six preceding plan years. The shortfall amortization installments with respect to a shortfall amortization base for a plan year are annual installments determined as the amount needed to amortize the shortfall amortization base in level annual installments over the seven-year period beginning with the plan year. The shortfall amortization installments for a plan year are determined using the appropriate segment interest rates for the plan year (discussed below).

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year, that is, the amount by which the plan's funding target for the year exceeds the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance). The shortfall amortization base is the excess of (1) the funding shortfall, over (2) the present value of (a) the aggregate shortfall amortization installments for the plan year and the five succeeding plan years that have been determined with respect to any shortfall amortization bases for each of the six preceding plan years and (b) the aggregate waiver amortization installments (discussed below) for the plan year and the four succeeding plan years that have been determined with respect to any waived funding deficiency for each of the five preceding plan years. Under a special rule, a shortfall amortization base does not have to be established for a year if the value of a plan's assets (reduced by any prefunding balance, but only

[23] Benefits accruing during the plan year are taken into account in determining normal cost for the plan year.

if the employer elects to use the prefunding balance to reduce required contributions for the year) is at least equal to the plan's funding target for a plan year.

A transition rule applies with respect to certain plans in determining a shortfall amortization base for a plan year beginning after 2006 and before 2011. The transition rule applies to a plan that is subject to the present-law funding rules for the 2006 plan year, but is not subject to the present-law deficit reduction contribution rules for that year. Under the transition rule, for purposes of determining a shortfall amortization base for a plan year, the plan's funding shortfall is calculated by reference to the applicable percentage of the plan's funding target as shown in the following table:

Calendar year in which plan year begins:	***Applicable percentage of funding target:***
2007	92 percent
2008	94 percent
2009	96 percent
2010	98 percent

Early deemed amortization of funding shortfalls for preceding years

If a plan's funding shortfall for a plan year is zero (i.e., the value of the plan's assets, reduced by any funding standard carryover balance and prefunding balance, is at least equal to the plan's funding target for the year), any shortfall amortization bases for preceding plan years are eliminated. In that case, for purposes of determining any shortfall amortization charges for that year and succeeding years, the shortfall amortization base for preceding years is zero.

Waiver amortization charges

The proposal retains the present-law rules under which the Secretary of the Treasury may waive all or a portion of the contributions required under the minimum funding standard for a plan year (referred to as a "waived funding deficiency").[24] If a plan has a waived funding deficiency for a plan year or any of the four preceding plan years, the minimum required contribution for the plan year is increased by the waiver amortization charge for the plan year.

[24] In the case of single-employer plans, the proposal repeals the present-law rules under which the amortization period applicable to an unfunded past service liability or loss may be extended.

The waiver amortization charge for a plan year is the aggregate of the waiver amortization installments for the plan year with respect to any waiver amortization bases for the five preceding plan years. The waiver amortization installments with respect to a waiver amortization base for a plan year are annual installments determined as the amount needed to amortize the waiver amortization base in level annual installments over the five-year period beginning with the following plan year. The waiver amortization installments for a plan year are determined using the appropriate segment interest rates for the plan year (discussed below). The waiver amortization base for a plan year is the amount of the waived funding deficiency (if any) for the plan year.

If a plan's funding shortfall for a plan year is zero (i.e., the value of the plan's assets, reduced by any funding standard carryover balance and prefunding balance, is at least equal to the plan's funding target for the year), any waiver amortization bases for preceding plan years are eliminated. In that case, for purposes of determining any waiver amortization charges for that year and succeeding years, the waiver amortization base for preceding years is zero.

Actuarial assumptions used in determining a plan's target normal cost and funding target

Interest rates

The proposal specifies the interest rates that must be used in determining a plan's target normal cost and funding target. Under the proposal, present value is determined using three interest rates ("segment" rates), each of which applies to benefit payments expected to be made from the plan during a certain period. The first segment rate applies to payments expected to be made during the five-year period beginning on the first day of the plan year; the second segment rate applies to payments expected to be made during the 15-year period following the initial five-year period; and the third segment rate applies to payments expected to be made after the end of the 15-year period. Each segment rate is a single interest rate determined monthly by the Secretary of the Treasury on the basis of a corporate bond yield curve, taking into account only the portion of the yield curve based on corporate bonds maturing during the particular segment rate period.

The corporate bond yield curve used for this purpose is to be prescribed on a monthly basis by the Secretary of the Treasury, reflecting a three-year weighted average of yields on investment grade corporate bonds with varying maturities. The three-year weighted average is an average determined using a methodology under which the most recent year is weighted 50 percent, the preceding year is weighted 35 percent, and the second preceding year is weighted 15 percent.

The Secretary of the Treasury is directed to publish each month the corporate bond yield curve and each of the segment rates for the month. In addition, such Secretary is directed to publish a description of the methodology used to determine the yield curve and segment rates, which is sufficiently detailed to enable plans to make reasonable projections regarding the yield curve and segment rates for future months, based on a plan's projection of future interest rates.

Under the proposal, the present value of liabilities under a plan is determined using the segment rates for the "applicable month" for the plan year. The applicable month is the month that includes the plan's valuation date for the plan year, or, at the election of the plan sponsor, any of the four months preceding the month that includes the valuation date. An election of a preceding month applies to the plan year for which it is made and all succeeding plan years unless revoked with the consent of the Secretary of the Treasury.

The proposal provides a transition rule for plan years beginning in 2007 and 2008.[25] Under this rule, for plan years beginning in 2007, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by the 33-⅓ percent; and (2) the product of the interest rate applicable in determining current liability for plan years beginning in 2006,[26] multiplied by 66-⅔ percent. For plan years beginning in 2008, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by the 66-⅔ percent; and (2) the product of the interest rate applicable in determining current liability for plan years beginning in 2006, multiplied by 33-⅓ percent.

Under the proposal, certain amounts are determined using the plan's "effective interest rate" for a plan year. The effective interest rate with respect to a plan for a plan year is the single rate of interest which, if used to determine the present value of the liabilities taken into account in determining the plan's funding target for the year, would result in an amount equal to the plan's funding target (as determined using the first, second, and third segment rates).

Mortality table

The proposal specifies the mortality table that must be used in determining present value or making any other computations. In general, the mortality table used must be the RP-2000 Combined Mortality Table, using Scale AA, as published by the Society of Actuaries, as in effect on the date of the enactment of the proposal. Under Treasury regulations, any difference in mortality assumptions under this required mortality table and the table used in determining current liability for plan years beginning in 2006 is to be phased in ratably over the first five plan years beginning in or after 2007, so as to be fully effective for the fifth plan year.[27]

The Secretary of the Treasury is directed to make revisions at least every 10 years in any tables in effect under the proposal to reflect the actual experience of pension plans and projected trends in such experience.

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[25] The transition rule does not apply to a plan if its first plan year begins after December 31, 2006.

[26] Under the proposal relating to the interest rate used for 2006, the interest rate applicable in determining current liability for plan years beginning in 2006 must be within a permissible range (from 90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins.

[27] The transition rule does not apply to a plan if its first plan year begins after December 31, 2006.

The proposal also provides for the use of a different mortality table with respect to a plan, as requested by the plan sponsor and approved by the Secretary of Treasury. In order for the table to be used, the Secretary must determine that the table (1) reflects the actual experience of the pension plan and projected trends in such experience and (2) is significantly different from the table otherwise required to be used. Such a table may generally be used for up to 10 years. However, the table shall no longer apply if the plan's actuary determines that the plan no longer meets the applicable criteria. A mortality table submitted to the Secretary for approval under the provision is treated as in effect for the succeeding plan year unless the Secretary, within the 180-day period beginning on the date of the submission, disapproves of the table and provides the reasons that the table fails to meet the applicable criteria.

Other assumptions

Under the proposal, in determining any present value or making any computation, the probability that future benefits will be paid in optional forms of benefit provided under the plan must be taken into account (including the probability of lump-sum distributions determined on the basis of the plan's experience and other related assumptions). In addition, there must be taken into account any difference in the present value of future benefit payments resulting from the use of actuarial assumptions, in determining benefit payments in any such optional form of benefit, that are different from those specified under the proposal.

The proposal generally does not require other specified assumptions to be used in determining the plan's target normal cost and funding target except in the case of at-risk plans (discussed below). However, similar to present law, the determination of present value or other computation must be made on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.[28]

Special assumptions for at-risk plans

The proposal applies special rules in determining the funding target and normal cost of a plan in at-risk status. A plan is in at-risk status for a plan year if the plan's funding target attainment percentage for the preceding year was less than 60 percent. A plan's funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the value of the plan's assets (reduced by the funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year. For this purpose, the plan's funding target is determined using the actuarial assumptions for plans that are not at-risk.

The funding target of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of all liabilities to participants and beneficiaries under the plan for the plan year, determined using (in addition to the normally required assumptions) an assumption that all

[28] The proposal retains the present-law rule under which certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

participants will elect benefits at the times and in the forms as will result in the highest present value of liabilities, plus (2) a loading factor. The loading factor is the sum of (1) $700 times the number of participants in the plan, plus (2) four percent of the funding target determined without regard to the loading factor.[29]

The target normal cost of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of benefits expected to accrue or be earned under the plan during the plan year, determined using (in addition to the normally required assumptions) an assumption that all participants will elect benefits at the times and in the forms that will result in the highest present value, plus (2) a loading factor. The loading factor is four percent of the target normal cost determined without regard to the loading factor.[30]

If a plan has been in at-risk status for fewer than five consecutive plan years, the amount of a plan's funding target or target normal cost for a plan year is determined as the sum of: (1) the amount of the funding target or target normal cost determined without regard to the at-risk rules, plus (2) the transition percentage for the plan year of the excess the amount of the funding target or target normal cost determined under the at-risk rules over the amount determined without regard to the at-risk rules. The transition percentage is the product of 20 percent times the number of consecutive plan years for which the plan has been in at-risk status.

Funding standard carryover balance or prefunding balance

In general

If the value of a plan's assets (reduced by any prefunding balance) is at least 80 percent of the plan's funding target (determined without regard to the at-risk rules) for the preceding plan year, the plan sponsor may elect to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year (determined after any funding waiver), thus reducing the amount that must be contributed for the current year.

The value of plan assets is generally reduced by any prefunding balance or funding standard carryover balance for purposes of determining minimum required contributions. However, the plan sponsor may elect to reduce the prefunding balance or funding standard carryover balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year. Any reduction of the prefunding balance or funding standard carryover balance applies before determining the balance that is available for crediting against minimum required contributions for the plan year.

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[29] This loading factor is intended to reflect the cost of purchasing group annuity contracts in the case of termination of the plan.

[30] Target normal cost for a plan in at-risk status does not include a loading factor of $700 per plan participant.

Funding standard carryover balance

In the case of a single-employer plan that is in effect for a plan year beginning in 2006 and, as of the end of the 2006 plan year, has a positive balance in the funding standard account maintained under the funding rules as in effect for 2006, the plan sponsor may elect to maintain a funding standard carryover balance. The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2006 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

As of the valuation date for each plan year beginning after 2007, the funding standard carryover balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Prefunding balance

The plan sponsor may elect to maintain a prefunding balance, which consists of a beginning balance of zero, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

As of the valuation date for each plan year beginning after 2007 (the "current" plan year), the prefunding balance of a plan is increased by the amount elected by the plan sponsor, not to exceed: (1) the excess (if any) of the aggregate total employer contributions for the preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, the minimum required contribution for the preceding plan year is increased by interest, at the plan's effective rate for the preceding plan year, on any portion of the required contribution remaining unpaid as of the valuation date for the current plan year, for the period beginning with the first day of the preceding plan year and ending on the date that the unpaid portion of the contribution is made.

As of the valuation date for each plan year beginning after 2007, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions). As discussed above, if the prefunding balance is used to reduce a minimum required contribution, the value of plan assets must be reduced by the prefunding balance in determining whether a shortfall amortization base must be established for the plan year (i.e., whether the value of plan assets for a plan year is less than the plan's funding target for the plan year). Thus, the prefunding balance may not be included in the value of plan assets in order to avoid a shortfall amortization base for a plan year and also used to reduce the minimum required contribution for the same year.

Other rules

In determining the prefunding balance or funding standard carryover balance as of the valuation date for a plan year (before applying any increase or decrease as described above), the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary of the Treasury, to reflect the rate of net gain or loss on plan assets. The rate of net gain or loss is determined on the basis of the fair market value of the plan assets and the gain or loss experienced by all plan assets for the period beginning with the valuation date for the preceding plan year and ending with the date preceding the valuation date for the current plan year, properly taking into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

To the extent that a plan has a funding standard carryover balance of more than zero for a plan year, none of the plan's prefunding balance may be credited to reduce a minimum required contribution, nor may an election be made to reduce the prefunding balance for purposes of determining the value of plan assets. Thus, the funding standard carryover balance must be used for these purposes before the prefunding balance may be used.

Any election relating to the prefunding balance and funding standard carryover balance is to be made in such form and manner as the Secretary of the Treasury prescribes.

Other rules and definitions

Valuation date

Under the proposal, all determinations made with respect to minimum required contributions for a plan year (such as the value of plan assets and liabilities) must be made as of the plan's valuation date for the plan year. In general, the valuation date for a plan year must be the first day of the plan year. However, any day in the plan year may be designated as the plan's valuation date if, on each day during the preceding plan year, the plan had 500 or fewer participants.[31] For this purpose, all defined benefit pension plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of such employer's controlled group, are treated as a single plan, but only participants with respect to such employer or controlled group member are taken into account.

Value of plan assets

The proposal allows the value of plan assets to be determined on the basis of any reasonable actuarial valuation method as under present law, with certain modifications. Any actuarial valuation method used may not result in a determination of the value of plan assets that at any time is less than 90 percent or more than 110 percent of the fair market value of the assets

[31] In the case of a plan's first plan year, the ability to use a valuation date other than the first day of the plan year is determined by taking into account the number of participants the plan is reasonably expected to have on each day during that first plan year.

at that time. In addition, a valuation method may not provide for averaging of fair market values over more than the three most recent plan years (including the current year).

If a required contribution for a preceding plan year is made after the valuation date for the current year, the contribution is taken into account in determining the value of plan assets for the current plan year. For plan years beginning after 2007, the contribution is taken into account in the amount of its present value as of the valuation date for the current plan year, determined using the plan's effective rate of interest for the preceding plan year. In addition, any required contribution for the current plan year is not taken into account in determining the value of plan assets. If a required contribution for the current plan year is made before the valuation date, the value of plan assets is reduced for interest on the contribution for the period from the time of contribution to the valuation date, determined using the plan's effective rate of interest for the current plan year.

Timing rules for contributions

As under present law, the due date for the payment of a minimum required contribution for a plan year is 8-½ months after the end of the plan year. Any payment made on a date other than the valuation date for the plan year must be adjusted for interest at the plan's effective rate of interest for the plan year for the period between the valuation date and the payment date. Similar to present-law rules, quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year (that is, if the value of the plan's assets, reduced by the funding standard carryover balance and prefunding balance, was less than the plan's funding target for the preceding plan year).[32]

Excise tax on failure to make minimum required contributions

The proposal retains the present-law rules under which an employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.[33] The excise tax is 10 percent of the aggregate unpaid minimum required contributions for all plan years remaining unpaid as of the end of any plan year. In addition, a tax of 100 percent may be imposed if any unpaid minimum required contributions remain unpaid after a certain period.

Conforming changes

The proposal makes various technical and conforming changes to reflect the new funding requirements.

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[32] The proposal also retains the present-law rules under which the amount of any quarterly installment must be sufficient to cover any liquidity shortfall.

[33] The proposal retains the present-law rules under which a lien in favor of the plan with respect to property of the employer (and members of the employer's controlled group) arises in certain circumstances in which the employer fails to make required contributions.

Effective Date

The extension of the present-law interest rate is effective for plan years beginning after December 31, 2005, and before January 1, 2007. The modifications to the single-employer plan funding rules are generally effective for plan years beginning after December 31, 2006.

B. Benefit Limitations Under Single-Employer Defined Benefit Pension Plans

1. Prohibition on shutdown benefits and other unpredictable contingent event benefits

Present Law

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce. Under present law, unpredictable contingent event benefits generally are not taken into account for funding purposes until the event has occurred.

Defined benefit pension plans are not permitted to provide "layoff" benefits (i.e., severance benefits).[34] However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.[35]

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[36] This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued. In general, an amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, certain notice requirements are met.

For purposes of the anticutback rule, an amendment is also 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.

Description of Proposal

Under the proposal, a single-employer defined benefit pension plan may not provide benefits to which participants are entitled solely by reason of the occurrence of: (1) a plant shutdown; or (2) any other unpredictable contingent event. For this purpose, the term unpredictable contingent event means an event other than: (1) attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability; or (2) an event which is reasonably and reliably predictable (as determined by the Secretary of the Treasury).

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[34] Treas. Reg. sec. 1.401-1(b)(1)(i).

[35] See, e.g., Treas. Reg. secs. 1.401(a)(4)-3(f)(4) and 1.411(a)-7(c).

[36] Code sec. 411(d)(6); ERISA sec. 204(g).

Under the proposal, a plan does not fail to meet the requirements of the anti-cutback rule solely by reason of the adoption of a plan amendment necessary to meet the requirements of the proposal.

Effective Date

The proposal generally applies with respect to plant shutdowns, or other unpredictable contingent events, occurring after December 31, 2006.

In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before the date of enactment of the proposal, the proposal does not apply to plan years beginning before the earlier of: (1) the later of (a) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of enactment), or (b) the first day of the first plan year to which the proposal would otherwise apply; or (2) January 1, 2009. For this purpose, any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to any requirement under the proposal is not to be treated as a termination of the collective bargaining agreement.

2. Funding-based limits on benefits and benefit accruals

Present Law

In general

Under present law, various restrictions may apply to benefit increases and distributions from a defined benefit pension plan, depending on the funding status of the plan.

Limitation on certain benefit increases while funding waivers in effect

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.[37] A waiver may be granted if the employer responsible for the contribution could not make the required contribution without temporary substantial business hardship for the employer (and members of the employer's controlled group) and if requiring the contribution would be adverse to the interests of plan participants in the aggregate.

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.[38]

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

[38] Code sec. 412(f); ERISA sec. 304(b)(1).

Security for certain plan amendments

In the case of a single-employer defined benefit pension plan, if a plan amendment increasing current liability is adopted and the plan's funded current liability percentage is less than 60 percent (taking into account the effect of the amendment, but disregarding any unamortized unfunded old liability), the employer and members of the employer's controlled group must provide security in favor of the plan.[39] The amount of security required is the excess of: (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) $10 million. The amendment is not effective until the security is provided.

The security must be in the form of a bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. The security is released after the funded liability of the plan reaches 60 percent.

Prohibition on benefit increases during bankruptcy

Subject to certain exceptions, if an employer maintaining a single-employer defined benefit pension plan is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.[40]

Restrictions on benefit payments due to liquidity shortfalls

In the case of a single-employer plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year. If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall"). In general, a plan has a liquidity shortfall for a quarter if the plan's liquid assets (such as cash and marketable securities) are less than a certain amount (generally determined by reference to disbursements from the plan in the preceding 12 months).

If a quarterly installment is less than the amount required to cover the plan's liquidity shortfall, limits apply to the benefits that can be paid from a plan during the period of underpayment. During that period, the plan may not make any prohibited payment, defined as: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) in the case of a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an

[39] Code sec. 401(a)(29); ERISA sec. 307.

[40] Code sec. 401(a)(33); ERISA sec. 204(i).

irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); or (3) any other payment specified by the Secretary of the Treasury by regulations.[41]

Prohibition on reductions in accrued benefits

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.[42] This restriction is sometimes referred to as the "anticutback" rule and applies to benefits that have already accrued. In general, an amendment may reduce the amount of future benefit accruals, provided that, in the case of a significant reduction in the rate of future benefit accrual, certain notice requirements are met.

For purposes of the anticutback rule, an amendment is also 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.

Description of Proposal

In general

Under the proposal, in the case of an underfunded single-employer defined benefit pension plan, limitations may apply with respect to: (1) plan amendments increasing benefit liabilities; (2) certain forms of distribution; and (3) benefit accruals.

Limitations on plans less than 80-percent funded

Limitations on plan amendments increasing benefit liabilities

Certain plan amendments may not take effect during a plan year if the plan's funding target attainment percentage for the plan year: (1) is less than 80 percent; or (2) would be less than 80 percent taking into account the amendment.[43] In such a case, no amendment may take effect if it has the effect of increasing the liabilities of the plan by reason of any increase in benefits, the establishment of new benefits, any change in the rate of benefit accrual, or any change in the rate at which benefits vest under the plan. For this purpose, any increase in benefits by reason of an increase in the benefit rate provided under the plan or on the basis of an increase in compensation is treated as effected by a plan amendment.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year (or, if later, the effective date of the amendment), if the plan sponsor makes a

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[41] Code sec. 401(a)(32); ERISA sec. 206(e).

[42] Code sec. 411(d)(6); ERISA sec. 204(g).

[43] Under the proposal, the present-law rules limiting benefit increases while an employer is in bankruptcy continue to apply.

contribution (in addition to any minimum required contribution for the plan year), equal to: (1) if the plan's funding target attainment percentage is less than 80 percent, the amount of the increase in the plan's funding target for the plan year attributable to the amendment; or (2) if the plan's funding target attainment percentage would be less than 80 percent taking into account the amendment, the amount sufficient to result in a funding target attainment percentage of 80 percent. In addition, the limitation does not apply to a plan for the first five years the plan (or a predecessor plan) is in effect.

Funding-based limitation on certain forms of distribution

A plan must provide that, if the plan's funding target attainment percentage is less than 80 percent for a plan year, the plan will not make any prohibited payments after the valuation date for the plan year. For this purpose, prohibited payment is defined as under the present-law rule restricting distributions during a period of a liquidity shortfall: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) in the case of a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); or (3) any other payment specified by the Secretary of the Treasury by regulations. However, the restriction on distributions does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on June 29, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period.

Additional limitation on benefit accruals for plans less than 60-percent funded

A plan must provide that, if the plan's funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year. However, this limitation does not apply to a plan for the first five years the plan (or a predecessor plan) is in effect.

Funding target attainment percentage

The term "funding target attainment percentage" means the ratio, expressed as a percentage, that the value of the plan's assets (reduced by the plan's funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (i.e., the present value of liabilities under the plan).[44] For this purpose, the plan's funding target is determined using the actuarial assumptions for plans that are not at-risk. However, under a special rule, if a plan's funding target attainment percentage is at least 100 percent, determined by not reducing the value of the plan's assets by the plan's funding standard carryover balance and prefunding balance, such reductions do not apply for this purpose.

[44] Funding target attainment percentage is defined for this purpose as under the proposal relating to minimum funding rules for single-employer plans.

Determining funding levels

Under the proposal, certain presumptions apply in determining whether limitations apply with respect to a plan, subject to certification of the plan's funding target attainment percentage by the plan's enrolled actuary. If a plan was subject to a limitation for the preceding year, the plan's funding target attainment percentage for the current year is presumed to be the same as the preceding year until the plan actuary certifies the plan's actual funding target attainment percentage for the current year. If (1) a plan was not subject to a limitation for the preceding year, but its funding target attainment percentage for the preceding year was not more than 10 percentage points greater than the threshold for a limitation, and (2) as of the first day of the fourth month of the current plan year, the plan actuary has not certified the plan's actual funding target attainment percentage for the current year, the plan's funding target attainment percentage is presumed to be reduced by 10 percentage points as of that day and that day is deemed to be the plan's valuation date for purposes of applying the benefit limitation. As a result, the limitation applies as of that date until the actuary certifies the plan's actual funding target attainment percentage. In any other case, if the plan actuary has not certified the plan's actual funding target attainment percentage by the first day of the tenth month of the current plan year, for purposes of the limitations, the plan's funding target attainment percentage is conclusively presumed to be less than 60 percent as of that day and that day is deemed to be the valuation date for the current plan year.

A special rule applies in applying the presumption rules in 2007. Under the special rule, the plan's "modified current liability percentage" for 2006 is substituted for the plan's funding target attainment percentage for the preceding plan year. Modified funding current liability percentage is the plan's funded current liability percentage for 2006, determined by reducing the value of the plan's assets by any credit balance if the plan's funded current liability percentage (before such a reduction) is less than 100 percent.

Anticutback relief

Under the proposal, a plan does not fail to meet the requirements of the anti-cutback rule solely by reason of the adoption of a plan amendment necessary to meet the requirements of the proposal.

Restoration of benefits

If a limitation on distributions or accruals apply with respect to a plan year (other than because of a presumption as to the plan's funding target attainment percentage) and the limitation ceases to apply for a subsequent year, the plan may provide for the resumption of such distributions or accruals only by means of the adoption of a plan amendment after the valuation date for the subsequent plan year.

Effective Date

The proposal generally applies with respect to plan years beginning after December 31, 2006.

In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before the date of enactment of the proposal, the proposal does not apply to plan years beginning before the earlier of: (1) the later of (a) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of enactment, or (b) the first day of the first plan year to which the proposal would otherwise apply; or (2) January 1, 2009. For this purpose, any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to any requirement under the proposal is not to be treated as a termination of the collective bargaining agreement.

C. Modification of Transition Rule to Pension Funding Requirements for Interstate Bus Company

Present Law

Defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required if a single-employer defined benefit pension plan is underfunded. Additional contributions generally are not required in the case of a plan with a funded current liability percentage of at least 90 percent. A plan's funded current liability percentage is the value of plan assets as a percentage of current liability. In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.

The PBGC insures benefits under most single-employer defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on the amount of unfunded vested benefits under the plan. A specified interest rate and a specified mortality table apply in determining unfunded vested benefits for this purpose.

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

The special rule generally treats a plan to which it applies as having a funded current liability percentage of at least 90 percent for plan years beginning after 1996 and before 2004 if for such plan year the funded current liability percentage is at least 85 percent. If the funded current liability of the plan is less than 85 percent for any plan year beginning after 1996 and before 2004, the relief from the minimum funding requirements generally applies only if certain specified contributions are made.

For plan years beginning in 2004 and 2005, the funded current liability percentage of the plan is treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for these years, additional contributions and quarterly contributions are not required with respect to the plan. In addition, for these years, the mortality table used under the plan is used in determining the amount of unfunded vested benefits under the plan for purposes of calculating PBGC variable rate premiums.

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

Description of Proposal

The proposal revises the special rule for a plan that is sponsored by a company engaged primarily in interurban or interstate passenger bus service and that meets the other requirements for the special rule under present law. The proposal extends the application of the special rule for plan years beginning in 2004 and 2005 to plan years beginning in 2006. The proposal also provides several special rules relating to determining minimum required contributions and unfunded vested benefits for plan years beginning after 2006 when the new funding rules for single-employer plans apply.

Under the proposal, for the plan year beginning in 2006, a plan's funded current liability percentage of a plan is treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for the 2006 plan year, additional contributions and quarterly contributions are not required with respect to the plan. In addition, the mortality table used under the plan is used in determining the amount of unfunded vested benefits under the plan for purposes of calculating PBGC variable rate premiums.

Under the proposal, for plan years beginning after 2006, the mortality table used under the plan is used in determining: (1) any present value or making any computation under the minimum funding rules applicable to the plan; and (2) the amount of unfunded vested benefits under the plan for purposes of calculating PBGC variable rate premiums. Under a special phase-in, for purposes of determining the plan's funding shortfall for plan years beginning after 2006 and before 2012, the applicable percentage of the plan's funding shortfall is the following: 90 percent for 2007, 92 percent for 2008, 94 percent for 2009, 96 percent for 2010, and 98 percent for 2011.[45] In addition, in determining minimum required contributions for plan years beginning after 2006, the value of plan assets is reduced only by the plan's prefunding balance (i.e., not by the plan's funding standard carryover balance) if, pursuant to a written agreement with the PBGC entered into before January 1, 2007, the funding standard carryover balance is not available to reduce the minimum required contribution for the plan year. Moreover, for purposes of the quarterly contributions requirement, the plan is treated as not having a funding shortfall for any plan year. As a result, quarterly contributions are not required with respect to the plan.

Effective Date

The proposal is effective for plan years beginning after December 31, 2005.

[45] The term "funding shortfall" is defined under the proposal relating to minimum funding rules for single-employer plans and means: (1) the excess (if any) of the plan's funding target for the plan year (i.e., the present value of liabilities under the plan), over (2) the value of the plan's assets, reduced by any prefunding and funding standard carryover balances.

D. Treatment of Nonqualified Deferred Compensation Plan when Employer's Defined Benefit Plan is in At-Risk Status

Present Law

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.[46] For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. If the requirements are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

In the case of assets set aside in a trust (or other arrangement) for purposes of paying nonqualified deferred compensation, such assets are treated as property transferred in connection with the performance of services under Code section 83 at the time set aside if such assets (or trust or other arrangement) are located outside of the United States or at the time transferred if such assets (or trust or other arrangement) are subsequently transferred outside of the United States. A transfer of property in connection with the performance of services under Code section 83 also occurs with respect to compensation deferred under a nonqualified deferred compensation plan if the plan provides that upon a change in the employer's financial health, assets will be restricted to the payment of nonqualified deferred compensation.

Description of Proposal

Under the proposal, if during any period in which a defined benefit pension plan of an employer is in at-risk status,[47] assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or other arrangement, for purposes of paying deferred compensation, such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83.

If a nonqualified deferred compensation plan of an employer provides that assets will be restricted to the provision of benefits under the plan in connection with the at-risk status (or other similar financial measure determined by the Secretary of Treasury) of any defined benefit pension plan of the employer, or assets are so restricted, such assets are treated as property

[46] Code section 409A.

[47] At-risk status is defined as under the proposal relating to funding rules for single-employer defined benefit pension plans and applies if a plan's funding target attainment percentage for the preceding year was less than 60 percent.

transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83.

Any subsequent increases in the value of, or any earnings with respect to, transferred or restricted assets are treated as additional transfers of property. Interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the amounts been includible in income for the taxable year in which first deferred or, if later, the first taxable year not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to an additional 20-percent tax.

For years before 2007, the proposal applies if the modified funded current liability percentage of the defined benefit pension plan for the preceding plan year is less than 60 percent. The modified funded current liability percentage is the funded current liability percentage reduced by any credit balance.

Effective Date

The proposal is effective for transfers or other reservations of assets after December 31, 2005.

II. FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS

A. Funding Rules for Multiemployer Defined Benefit Plans

Present Law

Multiemployer plans

A multiemployer plan is a plan to which more than one unrelated employer contributes, which is established pursuant to one or more collective bargaining agreements, and which meets such other requirements as specified by the Secretary of Labor. Multiemployer plans are governed by a board of trustees consisting of an equal number of employer and employee representatives. In general, the level of contributions to a multiemployer plan is specified in the applicable collective bargaining agreements, and the level of plan benefits is established by the plan trustees.

Defined benefit multiemployer plans are subject to the same general minimum funding rules as single-employer plans, except that different rules apply in some cases. For example, different amortization periods apply for some costs in the case of multiemployer plans. In addition, the deficit reduction contribution rules do not apply to multiemployer plans.

Funding standard account

As an administrative aid in the application of the funding requirements, a defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits are made for each plan year, including a charge for normal cost and credits for contributions to the plan. Other credits or charges or credits may apply as a result of decreases or increases in past service liability as a result of plan amendments or experience gains or losses, gains or losses resulting from a change in actuarial assumptions, or a waiver of minimum required contributions.

If, as of the close of the plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." For example, if the balance of charges to the funding standard account of a plan for a year would be $200,000 without any contributions, then a minimum contribution equal to that amount would be required to meet the minimum funding standard for the year to prevent an accumulated funding deficiency. If credits to the funding standard account exceed charges, a "credit balance" results. The amount of the credit balance, increased with interest, can be used to reduce future required contributions.

Funding methods and general concepts

In general

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

Normal cost

The plan's normal cost for a plan year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. Specifically, it is the amount actuarially determined that would be required as a contribution by the employer for the plan year in order to maintain the plan if the plan had been in effect from the beginning of service of the included employees and if the costs for prior years had been paid, and all assumptions as to interest, mortality, time of payment, etc., had been fulfilled.

Supplemental cost

The supplemental cost for a plan year is the cost of future benefits that would not be met by future normal costs, future employee contributions, or plan assets. The most common supplemental cost is that attributable to past service liability, which represents the cost of future benefits under the plan: (1) on the date the plan is first effective; or (2) on the date a plan amendment increasing plan benefits is first effective. Other supplemental costs may be attributable to net experience losses, changes in actuarial assumptions, and amounts necessary to make up funding deficiencies for which a waiver was obtained. Supplemental costs must be amortized (i.e., recognized for funding purposes) over a specified number of years, depending on the source.

Valuation of assets

For funding purposes, the actuarial value of plan assets may be used, rather than fair market value. The actuarial value of plan assets is the value determined under a reasonable actuarial valuation method that takes into account fair market value and is permitted under Treasury regulations. Any actuarial valuation method used must result in a value of plan assets that is not less than 80 percent of the fair market value of the assets and not more than 120 percent of the fair market value. In addition, if the valuation method uses average value of the plan assets, values may be used for a stated period not to exceed the five most recent plan years, including the current year.

Reasonableness of assumptions

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

Charges and credits to the funding standard account

In general

Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. Other costs are spread (or amortized) over a period of years. In the case of a multiemployer plan, past service liability is amortized over 40 or 30 years depending on how the liability arose, experience gains and losses are amortized over 15 years, gains and losses from changes in actuarial assumptions are amortized over 30 years, and waived funding deficiencies are amortized over 15 years.

Normal cost

Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit. For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability

There are three separate charges to the funding standard account one or more of which may apply to a multiemployer plan as the result of past service liabilities. In the case of a plan in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA is amortized over 40 years. In the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan was first subject to ERISA is amortized over 30 years. Past service liability due to plan amendments is amortized over 30 years.

Experience gains and losses

In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. The actuarial assumptions are required to be reasonable, as discussed below. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. In the case of a multiemployer plan, experience gains and losses for a year are generally amortized over a 15-year period, resulting in credits or charges to the funding standard account.

Gains and losses from changes in assumptions

If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost or future employee contributions. In the case of a multiemployer plan, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 30 years, resulting in credits or charges to the funding standard account.

Funding waivers and amortization of waived funding deficiencies

Within limits, the Secretary of the Treasury is permitted to waive all or a portion of the contributions required under the minimum funding standard for the year (a "waived funding deficiency"). In the case of a multiemployer plan, a waiver may be granted if 10 percent or more of the number of employers contributing to the plan could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. The minimum funding requirements may not be waived with respect to a multiemployer plan for more five out of any 15 consecutive years.

If a funding deficiency is waived, the waived amount is credited to the funding standard account. In the case of a multiemployer plan, the waived amount is then amortized over a period of 15 years, beginning with the year following the year in which the waiver is granted. Each year, the funding standard account is charged with the amortization amount for that year unless the plan becomes fully funded. In the case of a multiemployer plan, the interest rate used for purposes of determining the amortization on the waived amount is the rate determined under section 6621(b) of the Internal Revenue Code (relating to the Federal short-term rate).

Extension of amortization periods

Amortization periods may be extended for up to 10 years by the Secretary of the Treasury if the Secretary finds that the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and if such Secretary determines that the failure to permit such an extension would (1) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or employee compensation, and (2) be adverse to the interests of plan participants in the aggregate. The interest rate with respect to extensions of amortization periods is the same as that used with respect to waived funding deficiencies.

Alternative funding standard account

As an alternative to applying the rules described above, a plan which uses the entry age normal cost method may satisfy an alternative minimum funding standard. Under the alternative, the minimum required contribution for the year is generally based on the amount necessary to bring the plan's assets up to the present value of accrued benefits, determine using the actuarial assumptions that apply when a plan terminates. The alternative standard has been rarely used.

Description of Proposal

The proposal modifies the amortization periods applicable to multiemployer plans so that the amortization period for most charges is 15 years. Under the proposal, in the case of a plan which was not in existence on January 1, 1974, past service liability under the plan on the first day on which the plan is first subject to ERISA is amortized over 15 years (rather than 30); past service liability due to plan amendments is amortized over 15 years (rather than 30); and experience gains and losses resulting from a change in actuarial assumptions are amortized over 15 years (rather than 30). As under present law, experience gains and losses and waived funding deficiencies are amortized over 15 years. The new amortization periods do not apply to amounts being amortized under present-law amortization periods, that is, no recalculation of amortization schedules already in effect is required under the proposal. The proposal eliminates the alternative funding standard account.

The proposal provides that in applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations). In addition, as under present law, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.

The proposal provides that, upon application to the Secretary of the Treasury, the Secretary is to grant an extension of the amortization period with respect to any unfunded past service liability, investment loss, or experience loss if the Secretary determines that (1) absent the extension, the plan would have an accumulated funding deficiency in any of the next ten plan years, (2) the plan sponsor has adopted a plan to improve the plan's funding status, and (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures. The extension may not exceed five years.

The Secretary of the Treasury may also grant an additional extension of such amortization periods for an additional five years. The standards for determining whether such an extension may be granted are the same as under present law.

As under present law, these extensions do not apply unless the applicant demonstrates to the satisfaction of the Treasury Secretary that notice of the application has been provided to each affected party (as defined in ERISA section 4001(a)(21)).

The proposal modifies the interest rate applicable to waived funding deficiencies and extensions of amortization periods so that it is the greater of (1) 150 percent of the Federal mid-term rate, or (2) the rate of interest used under the plan in determining costs.

Effective Date

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

B. Additional Funding Rules for Multiemployer Plans in Endangered or Critical Status

Present Law

Multiemployer defined benefit plans are subject to minimum funding rules similar to those applicable to single-employer plans.[48] Certain modifications to the single-employer plan funding rules apply to multiemployer plans that experience financial difficulties, referred to as "reorganization status." A plan is in reorganization status for a year if the contribution needed to balance the charges and credits to its funding standard account exceeds its "vested benefits charge."[49] The plan's vested benefits charge is generally the amount needed to amortize, in equal annual installments, unfunded vested benefits under the plan over: (1) 10 years in the case of obligations attributable to participants in pay status; and (2) 25 years in the case of obligations attributable to other participants. A plan in reorganization status is eligible for a special funding credit. In addition, a cap on year-to-year contribution increases and other relief is available to employers that continue to contribute to the plan.

Subject to certain requirements, a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC.[50] In order for accrued benefits to be reduced, at least six months before the beginning of the plan year in which the amendment is adopted, notice must be given that the plan is in reorganization status and that, if contributions to the plan are not increased, accrued benefits will be reduced or an excise tax will be imposed on employers obligated to contribute to the plan. The notice must be provided to plan participants and beneficiaries, any employer who has an obligation to contribute to the plan, and any employee organization representing employees in the plan.

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year.[51] An insolvent plan is required to reduce benefits to the level that can be covered by the plan's assets. However, benefits cannot be reduced below the level guaranteed by the PBGC.[52]

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[48] See section II.A. for a discussion of the minimum funding rules for multiemployer defined benefit plans.

[49] ERISA sec. 4241.

[50] ERISA sec. 4244A.

[51] ERISA sec. 4245.

[52] The limit of benefits that the PBGC guarantees under a multiemployer plan is the sum of 100 percent of the first $11 of monthly benefits and 75 percent of the next $33 of monthly benefits for each year of service. ERISA sec. 4022A(c).

If a multiemployer plan is insolvent, the PBGC guarantee is provided in the form of loans to the plan trustees. If the plan recovers from insolvency status, loans from the PBGC can be repaid. Plans in reorganization status are required to compare assets and liabilities to determine if the plan will become insolvent in the future.

Description of Proposal

In general

The proposal provides additional funding rules for multiemployer defined benefit plans that are in endangered or critical status. The present-law reorganization and insolvency rules continue to apply.

Within 90 days after the first day of the plan year, the plan actuary must certify to the Secretary of the Treasury whether or not the plan is in endangered or critical status for the plan year. If the certification is not made within this period, the plan is presumed to be in critical status until the plan actuary makes a contrary certification. In making the determination whether a plan is in endangered or critical status, the plan actuary must make projections for the current and succeeding plan years, using reasonable actuarial assumptions and methods, of the current value of plan assets and the present value of liabilities under the plan for the current year as of the beginning of the year, based on the actuarial statement for the preceding plan year. Any actuarial projection of plan assets must assume (1) reasonably anticipated employer and employee contributions for the current and succeeding plan years, assuming that the terms of one or more collective bargaining agreements pursuant to which the plain is maintained for the current plan year continue in effect for the succeeding plan years, or (2) that employer and employee contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines that there have been no significant demographic changes that would make continued application of such terms unreasonable.

If a plan is certified to be in endangered status or enters into critical status, notice must be provided within 30 days after the date of certification or entry to the participants and beneficiaries, the bargaining parties, the PBGC, the Secretary of the Treasury and the Secretary of Labor.

Endangered status

A multiemployer plan is in endangered status if the plan's funded percentage for the plan year is less than 80 percent, or the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over accrued liability of the plan.

Within 240 days after a plan is certified as endangered (if no funding improvement plan is in effect for the plan year), the plan sponsor must amend the multiemployer plan to include a funding improvement plan approved by the bargaining parties. The funding improvement plan must provide that during the funding improvement period, the plan will have a certain required increase in the funded percentage and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "benchmarks").

The proposal requires that the plan's funded percentage increase such that the difference between 100 percent and the plan's funded percentage for the last year of the funding improvement plan is not more than two-thirds of the difference between 100 percent and the plan's funded percentage for the first year of the funding improvement plan. Thus, the difference between 100 percent and the plan's funded percentage must be reduced by at least one-third during the funding improvement period. The funding improvement period is the 10-year period beginning on the earlier of (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the first day of the first plan year following the year (after certification of endangered status) in which the collective bargaining agreements covering at least 75 percent of active participants have expired.

In the case in which the funded percentage of a plan is 70 percent or less, the proposal requires that the plan's funded percentage increase such that the difference between 100 percent and the plan's funded percentage for the last year of the funding improvement plan is not more than four-fifths of the difference between 100 percent and the plan's funded percentage for the first year of the funding improvement plan. Thus, the difference between 100 percent and the plan's funded percentage must be reduced by at least one-fifth during the funding improvement period. In addition, a 15-year funding improvement period is used. If the plan year is prior to the first day of the first plan year following the plan year in which first occurs the first date (after the day of the certification) as of which collective bargaining agreements covering at least 75 percent of active participants in the multiemployer plan have expired, the same requirements apply in the case of a plan in which the funded percentage is more than 70 percent, but less than 80 percent, if the plan actuary certifies within 30 days after certification of endangered status that the plan is not able to attain the funding percentage increase otherwise required by the proposal (i.e., the difference between 100 percent and the plan's funded percentage must be reduced by at least one-third during the funding improvement period) over the funding improvement period. For subsequent years for such plans, if the plan actuary certifies that the plan is not able to attain the increase generally required under the proposal, a 15-year funding improvement period is used.

Within 90 days after a plan is certified as endangered, the plan sponsor must provide to the bargaining parties alternative proposals for revised benefit structures, contribution structures, or both, which if adopted as amendments to the plan may be reasonably expected to meet the benchmark requirements for the funding improvement plan. The proposals must include (1) at least one proposal for reductions in the amount of future benefit accruals necessary to achieve the benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law) and (2) at least one proposal for increases in contributions necessary to achieve the benchmarks assuming no amendments reducing future benefit accruals under the plan. Upon request of any bargaining party who employs at least five percent of the active participants, or represents as an employee organization at least five percent of the active participants, the plan sponsor must provide information on other combinations of increases in contributions and reductions in future benefit accruals which would result in achieving the benchmarks. The plan sponsor may provide additional information as it deems appropriate.

Pending approval of the funding improvement plan, the plan sponsor must take all reasonable actions (consistent with the terms of the plan and present law) necessary to ensure an increase in the plan's funded percentage and a postponement of an accumulated funding deficiency for at least one additional plan year. These actions include applications for extensions of amortization periods, use of the shortfall funding method in making funding standard account computations, amendments to the plan's benefit structure, reductions in future benefit accruals, and other reasonable actions.

In addition, pending approval of a funding improvement plan, the plan may not be amended to provide (1) a reduction in the level of contributions for participants who are not in pay status; (2) a suspension of contributions with respect to any period of service; or (3) any new or indirect exclusion of younger or newly hired employees from plan participation. Pending approval of a funding improvement plan, restrictions apply on lump sum and other similar distributions. If the present value of participant’s accrued benefit exceeds $5,000, the benefit may not be distributed as an immediate distribution or in any other accelerated form. In addition, except in the case of amendments required as a condition of qualification under the Internal Revenue Code, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable.

If no plan is adopted by the end of the 240-day period after a plan is certified as endangered, the plan enters into critical status as of the first day of the succeeding plan year. Notice must be provided to participants and beneficiaries, the bargaining parties, the PBGC, the Secretary of Treasury and the Secretary of Labor within 30 days after the plan enters critical status.

A summary of any funding improvement plan and any modifications, together with annual updates regarding the funding ratio of the plan, must be included in the plan's annual report and summary annual report.

Upon adoption of a funding improvement plan, the plan may not be amended to be inconsistent with the funding improvement plan, or to increase future benefit accruals, unless the plan actuary certifies in advance that, after taking into account the proposed increase, the plan is reasonably expected to meet the benchmarks.

Critical status

There are several ways that a multiemployer plan can be in critical status for a plan year. A multiemployer plan is in critical status for a plan year if:

1. As of the beginning of the current plan year, the funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value

of all nonforfeitable benefits for all participants and beneficiaries projected to be payable under the plan during the plan year and each of the six succeeding plan years (plus administrative expenses),

2. As of the beginning of the current plan year, the sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer and employee contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all nonforfeitable benefits for all participants and beneficiaries projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses),

3. As of the beginning of the current plan year, the funded percentage of the plan is less than 65 percent and the plan has an accumulated funding deficiency for the current plan year or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions),

4. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value (as of the beginning of the plan year) of the reasonably anticipated employer and employee contributions for the current plan year, (B) the present value (as of the beginning of the plan year) of nonforfeitable benefits of inactive participants is greater than the present value (as of the beginning of the current plan year) of nonforfeitable benefits of active participants, and (C) the plan is projected to have an accumulated funding deficiency for the current plan year or any of the four succeeding plan years (not taking into account amortization period extensions), or

5. (A) The funded percentage of the plan is greater than 65 percent for the current plan year and (B) the plan is projected to have an accumulated funding deficiency during any of the succeeding three plan years (not taking into account amortization period extensions).

As previously discussed, a plan is in critical status if the plan is in endangered status for the preceding plan year and the requirements applicable to endangered plans were not met with respect to the plan. A plan is also in critical status the annual certification whether a plan is in endangered or critical status is not made.

If a plan is in critical status for a plan year (and no rehabilitation plan is currently in effect for the plan year), the plan must be amended within 240 days after the plan enters critical status to include a rehabilitation plan. A plan is treated as entering into critical status as of the date that the plan is certified to be in critical status, is presumed to be in critical status because no certification is made, or enters into critical status because the requirements of endangered status are not satisfied.

A rehabilitation plan must consist of (1) amendments to the plan providing for measures, agreed to by the bargaining parties, to increase contributions, reduce plan expenditures, or reduce future benefit accruals, or to take any combination of such actions, determined necessary to cause the plan to cease to be in critical status during the rehabilitation period, or (2) reasonable measures to forestall possible insolvency if the plan sponsor determines that upon exhaustion of all reasonable measures, the plan would not cease to be in critical status during the rehabilitation period.

The rehabilitation period is the 10-year period beginning on the earlier of (1) the second anniversary of the date of adoption of the rehabilitation plan or (2) the first day of the first plan year following the year (after entry into critical status) in which the collective bargaining agreements covering at least 75 percent of active participants have expired.

Within 90 days after the date of entry into critical status the plan sponsor must propose to all bargaining parties a range of alternative schedules of increases in contributions and reductions in future benefit accruals that would carry out a rehabilitation plan. One schedule must show the reductions in future benefit accruals that would be necessary to cause the plan to cease to be in critical status if there were no further increases in rates of contribution to the plan. If the plan sponsor determines that the plan will not cease to be in critical status during the rehabilitation period unless the plan is amended to provide for an increase in contributions, one schedule must show the increases in contribution rates that would be necessary to cause the plan to cease to be in critical status if future benefit accruals were reduced to the maximum extent permitted by law. Upon request of any bargaining party who employs at least five percent of the active participants, or represents as an employee organization for purposes of collective bargaining at least five percent of the participants, the plan sponsor must include among the proposed schedules such schedules of increases in contributions and reductions in future benefit accruals as may be specified by the bargaining parties.

Any schedule including reductions in future benefit accruals forming part of a rehabilitation plan is applicable with respect to any group of active participants who are employed by any bargaining party in proportion to the extent to which increases in contributions under the schedule apply to such bargaining party. Any proposed schedule cannot reduce the rate of future accruals below the lower of (1) a monthly benefit equal to one percent of the contributions required to be made with respect to a participant or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the plan year in which the plans enters critical status, or (2) the accrual rate under the plan. The equivalent standard accrual rate is determined by the trustees based on the standard or average contribution base units that they determine to be representative for active participants and such other factors they determine to be relevant.

Pending approval of a rehabilitation plan, the plan may not be amended to provide (1) a reduction in the level of contributions for participants who are not in pay status; (2) a suspension of contributions with respect to any period of service; or (3) any new or indirect exclusion of younger or newly hired employees from plan participation. Pending approval of a funding improvement plan, restrictions apply on lump sum and other similar distributions. If the present value of participant's accrued benefit exceeds $5,000, the benefit may not be distributed as an immediate distribution or in any other accelerated form. In addition, pending approval of a rehabilitation plan, except in the case of amendments required as a condition of qualification under the Internal Revenue Code, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable.

Upon adoption of a rehabilitation plan, the plan may not be amended to be inconsistent with the rehabilitation plan or to increase future benefit accruals, unless the plan actuary certifies in advance, that after taking into account the proposed increase, the plan is reasonably expected to cease to be in critical status.

Upon the adoption of a schedule of increases in contributions or reduction in future benefit accruals as part of a rehabilitation plan, the plan sponsor may, no more than once in any three-year period, amend the plan to update the schedule to adjust for any experience of the plan contrary to past actuarial assumptions. A summary of the rehabilitation plan and any modifications, together with annual updates regarding the funding ratio of the plan, must be included in the annual report and summary annual report for the plan year.

The failure of an employer to make contributions in compliance with the rehabilitation schedule may, at the discretion of the plan sponsor, be treated as a complete or partial withdrawal from the plan.

If the rehabilitation plan is not adopted within the 240-day period after entry into critical status, the plan must be amended to implement the schedule proposed by the plan sponsor that shows the reductions in future benefit accruals that would be necessary to cause the plan to cease to be in critical status if there were no further increases in rates of contributions to the plan.

Effective Date

The proposal is effective for plan years beginning after December 31, 2005.

C. Measures to Forestall Insolvency of Multiemployer Plans

Present Law

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

In order to anticipate future insolvencies, at the end of the first plan year in which a plan is in reorganization and at least every three plans year thereafter, the plan sponsor must compare the value of plan assets for the plan year with the total amount of benefit payments made under the plan for the plan year.[53] Unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next three plan years.

Description of Proposal

Under the proposal, unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next five plan years. If the plan sponsor makes a determination that the plan will be insolvent for any of the next five plan years, the plan sponsor must make the comparison of plan assets and benefit payments under the plan at least annually until the plan sponsor makes a determination that the plan will not be insolvent in any of the next five plan years.

Effective Date

The proposal is effective with respect to determinations made in plan years beginning after December 31, 2005.

[53] Code sec. 418E(d)(1); ERISA sec. 4245(d)(1).

III. OTHER PROVISIONS

A. Interest Rate Assumption for Determination of Lump-Sum Distributions

Present law

Accrued benefits under a defined benefit pension plan generally must be paid in the form of an annuity for the life of the participant unless the participant consents to a distribution in another form. Defined benefit pension plans generally provide that a participant may choose among other forms of benefit offered under the plan, such as a lump-sum distribution. These optional forms of benefit generally must be actuarially equivalent to the life annuity benefit payable to the participant.

A defined benefit pension plan must specify the actuarial assumptions that will be used in determining optional forms of benefit under the plan in a manner that precludes employer discretion in the assumptions to be used. For example, a plan may specify that a variable interest rate will be used in determining actuarial equivalent forms of benefit, but may not give the employer discretion to choose the interest rate.

Statutory assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum.[54] That is, the lump sum payable under the plan may not be less than the amount of the lump sum that is actuarially equivalent to the life annuity payable to the participant, determined using the statutory assumptions. The statutory assumptions consist of an applicable mortality table (as published by the IRS) and an applicable interest rate.

The applicable interest rate is the annual interest rate on 30-year Treasury securities, determined as of the time that is permitted under regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant ("stability period") and the use of averaging.

Description of Proposal

The proposal changes the mortality table and interest rate used to calculate the minimum value of lump sums payable from a defined benefit pension plan.

The mortality table that must be used for calculating lump sums is based on the mortality the table required for minimum funding purposes (i.e., the RP-2000 Combined Mortality Table, using Scale AA, as published by the Society of Actuaries, as in effect on the date of enactment of the bill and revised from time to time) modified as appropriate by the Secretary of the Treasury. It is intended that the Secretary will prescribe gender-neutral tables for use in determining minimum lump sums.

[54] Code sec. 417(e)(3); ERISA sec. 205(g)(3).

The proposal provides that minimum lump-sum values are to be calculated using the adjusted first, second, and third segment rates as applied under the funding rules, with certain modifications, for the month before the date of distribution or such other time as the Secretary of the Treasury may prescribe by regulation. The adjusted first, second, and third segment rates are derived from a corporate bond yield curve prescribed by the Secretary of the Treasury for such month which reflects the yields on investment grade corporate bonds with varying maturities (rather than a three-year weighted average, as under the minimum funding rules). Thus, the interest rate that applies depends upon how many years in the future a participant's annuity payment will be made. Typically, a higher interest applies for payments made further out in the future.

A transition rule applies for distributions in 2007 through 2010. For distributions in 2007 through 2010, lump-sum values are determined as the weighted average of two values: (1) the value of the lump sum determined under the methodology under present law (the "old" methodology); and (2) the value of the lump sum determined using the methodology applicable for 2006 and thereafter (the "new" methodology). For distributions in 2007, the weighting factor is 80 percent for the lump-sum value determined under the old methodology and 20 percent for the lump-sum determined under the new methodology. For distributions in 2008, the weighting factor is 60 percent for the lump-sum value determined under the old methodology and 40 percent for the lump-sum determined under the new methodology. For distributions in 2009, the weighting factor is 40 percent for the lump-sum value determined under the old methodology and 60 percent for the lump-sum determined under the new methodology. For distributions in 2010, the weighting factor is 20 percent for the lump-sum value determined under the old methodology and 80 percent for the lump-sum determined under the new methodology.

The proposal also provides that a plan amendment requiring the use of the prescribed table and interest rate will not result in a violation of the rule that accrued benefits may not be decreased by plan amendment.

Effective Date

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

B. Interest Rate Assumption for Applying Benefit Limitations to Lump-Sum Distributions

Present Law

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) $170,000 (for 2005).[55] The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. For purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the rate applicable in determining minimum lump sums, i.e., the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. In the case of plan years beginning in 2004 or 2005, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.

Description of Proposal

Under the proposal, for purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) 5.5 percent; (2) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate applicable in determining minimum lump sums were used; or (3) the interest rate specified in the plan.

Effective Date

The proposal is effective for distributions made in years beginning after December 31, 2005.

[55] Code sec. 415(b).

C. Distributions During Working Retirement

Present Law

For purposes of the qualification requirements applicable to pension plans, stock bonus plans, and profit-sharing plans, a pension plan is a plan established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of year, usually life, after retirement.[56] A pension plan (i.e., a defined benefit plan or money purchase pension plan) may not provide for distributions before the attainment of normal retirement age (commonly age 65) to participants who have not separated from employment.[57]

Under proposed regulations, in the case of a phased retirement program, a pension plan is permitted to pay a portion of a participant's benefits before attainment of normal retirement age.[58] A phased retirement program is a program under which employees who are at least age 59-1/2 and are eligible for retirement may reduce (by at least 20 percent) the number of hours they customarily work and receive a pro rata portion of their retirement benefits, based on the reduction in their work schedule.

Description of Proposal

Under the proposal, a pension plan does not fail to be a qualified retirement plan merely because it provides for distributions to a participant who has attained age 62 and has not separated from employment at the time of the distribution.

Effective Date

The proposal is effective for plan years beginning after December 31, 2005.

[56] Treas. Reg. sec. 1.401-1(b)(1)(i).

[57] See, e.g., Rev. Rul. 74-254.

[58] Prop. Treas. Reg. secs. 1.401(a)-1(b)(1)(iv) and 1.401(a)-3.

IV. IMPROVEMENTS IN PBGC GUARANTEE PROVISIONS

Present Law

The PBGC

The minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the Pension Benefit Guaranty Corporation ("PBGC"), a corporation within the Department of Labor, was created in 1974 under ERISA to provide an insurance program for benefits under most defined benefit plans maintained by private employers.

Termination of single-employer defined benefit plans

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination. The PBGC may also involuntarily terminate a plan (that is, the termination is not voluntary on the part of the employer).

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities. If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer (and members of the employer's controlled group) meets one of four criteria of financial distress.[59]

The PBGC may institute proceedings to terminate a plan if it determines that the plan in question has not met the minimum funding standards, will be unable to pay benefits when due, has a substantial owner who has received a distribution greater than $10,000 (other than by reason of death) while the plan has unfunded nonforfeitable benefits, or may reasonably be expected to increase PBGC's long-run loss unreasonably. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

Guaranteed benefits

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early

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[59] The four criteria for a distress termination are: (1) the contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings; (2) the contributing sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding; (3) the PBGC determines that termination is necessary to allow the employer to pay its debts when due; or (4) the PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.

retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump-sum benefits payable to encourage early retirement) is guaranteed.[60]

Retirement benefits that begin before normal retirement age are guaranteed, provided they meet the other conditions of guarantee (such as that before the date the plan terminates, the participant had satisfied the conditions of the plan necessary to establish the right to receive the benefit other than application for the benefit). Contingent benefits (for example, subsidized early retirement benefits) are guaranteed only if the triggering event occurs before plan termination.

For plans terminating in 2005, the maximum guaranteed benefit for an individual retiring at age 65 is \$3,698.86 per month or \$44,386.32 per year.[61] The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.[62]

PBGC premiums

In general

The PBGC is funded by assets in terminated plans, amounts recovered from employers who terminate underfunded plans, premiums paid with respect to covered plans, and investment earnings. All covered single-employer plans are required to pay a flat per-participant premium and underfunded plans are subject to an additional rate variable premium based on the level of underfunding. The amount of both the flat rate premium and the variable rate premium are set by statute; the premiums are not indexed for inflation.

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[60] ERISA sec. 4022(b) and (c).

[61] The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

Special rules limit the guaranteed benefits of individuals who are substantial owners covered by a plans whose benefits have not been increased by reason of any plan amendment. A substantial owner generally is an individual who: (1) owns the entire interest in an unincorporated trade or business; (2) in the case of a partnership, is a partner who owns, directly or indirectly, more than 10 percent of either the capital interest or the profits interest in the partnership; (3) in the case of a corporation, owns, directly or indirectly, more than 10 percent in value of either the voting stock of the corporation or all the stock of the corporation; or (4) at any time within the preceding 60 months was a substantial owner under the plan. ERISA sec. 4022(b)(5).

[62] The phase in does not apply if the benefit is less than \$20 per month.

Flat rate premiums

The annual flat rate per participant premium is $19 per participant.

Variable rate premiums

The variable rate premium is equal to $9 per $1,000 of unfunded vested benefits. "Unfunded vested benefits" is the amount which would be the unfunded current liability (as defined under the minimum funding rules) if only vested benefits were taken into account and if benefits were valued at the variable premium interest rate. No variable rate premium is imposed for a year if contributions to the plan for the prior year were at least equal to the full funding limit for that year.

In determining the amount of unfunded vested benefits, the interest rate used is generally 85 percent of the interest rate on 30 year Treasury securities for the month preceding the month in which the plan year begins (100 percent of the interest rate on 30 year Treasury securities for plan years beginning in 2002 and 2003). Under PFEA 2004, in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes for plan years beginning after December 31, 2003, and before January 1, 2006, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

Description of Proposal

Flat rate premiums

Beginning in 2006, the proposal phases in an increase of the flat rate premium to $30 as adjusted for years after 2006 based on increases in average wages as defined under the Social Security Act.[63] The rate of the phase-in depends on the funded status of the plan. In general, the flat rate premium for a single-employer plan is determined under the following table:

If the plan year begins in:	The flat rate premium is:
2006	$21.20
2007	$23.40
2008	$25.60
2009	$27.80
2010 and thereafter	$30, as adjusted starting in 2007 for increases in average wages

[63] In general, if the premium amount as indexed is not a multiple of $1, the amount is rounded to the nearest $1; if the amount is a multiple of $.50, the amount is rounded to the next highest dollar amount.

A faster phase-in schedule applies to plans with funding below a certain level. If the funding target percentage of a plan for the preceding plan year was less than 80 percent, then the flat rate premium is determined under the following table:

If the plan year begins in:	The flat rate premium is:
2006	$22.67
2007	$26.33
2008 and thereafter	$30, as adjusted starting in 2007 for increases in average wages

Under the proposal, the same flat rate premium will apply to all plans, regardless of funding status, in 2010 and thereafter.

Variable rate premium

For 2006, the proposal extends the present-law rule under which, in determining the amount of unfunded vested benefits for variable rate premium purposes, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

Beginning in 2007, the determination of unfunded vested benefits for purposes of the variable rate premium is modified to conform to the funding rules of the proposal. Thus, under the proposal, unfunded vested benefits are equal to the amount which would be the plan's funding shortfall for the year[64] if plan assets were valued at fair market value and only vested benefits were taken into account.[65] In valuing unfunded vested benefits the interest rate is the first, second, and third segment rates which would be determined under the funding rules of the proposal, if the segment rates were based on the yields of corporate bond rates, rather than a three-year average of such rates. Under the proposal, deductible contributions are no longer limited by the full funding limit; thus, the rule providing that no variable rate premium is required if contributions for the prior plan year were at least equal to the full funding limit no longer applies under the proposal.

Premium for certain terminating plans

The proposal imposes a per-participant premium of $1,250 for each applicable 12-month period following certain plan terminations (called the "termination premium"). The termination premium applies if the plan is terminated by the PBGC or in a distress termination by reason of

[64] The assumptions used are the same as under the minimum funding rules. Thus, for a plan in at-risk status, the at-risk assumptions are used.

[65] For this purpose, the fair market value of plan assets is not reduced by the plan's prefunding balance and funding standard carryover balance.

(1) reorganization in bankrupty (or similar State proceeding), (2) the inability of the employer to pay its debts when due, or (3) a determination that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer's work force.

The applicable 12-month period is generally the 12-month period beginning with the month after the date in which the termination occurs and the next two 12-month periods. In the case of a termination due to reorganization, the first 12-month period does not start until discharge of the party in the reorganization proceeding.

Effective Date

The proposal relating to flat-rate premiums is effective for plan years beginning after December 31, 2005. The extension of the present-law interest rate for purposes of calculating the variable rate premium is effective for plan years beginning in 2006. The modifications to the variable rate premiums to conform to the new funding rules of the proposal are affective for plan years beginning after December 31, 2006. The proposal relating to termination premiums is effective for reorganization proceedings begun after October 26, 2005.

V. DISCLOSURE

A. Section 4010 Filings with the PBGC

Present Law

In some cases, certain financial information with respect to the members of a controlled group and actuarial information with respect to plans maintained by members of the controlled group must be reported annually to the PBGC ("section 4010 information").[66] This reporting is required if: (1) the aggregate unfunded vested benefits (determined using the interest rate used in determining variable-rate premiums) as of the end of the preceding plan year under all plans maintained by members of the controlled group exceed $50 million (disregarding plans with no unfunded vested benefits); (2) the conditions for imposition of a lien (i.e., required contributions totaling more than $1 million have not been made) have occurred with respect to an underfunded plan maintained by a member of the controlled group; or (3) minimum funding waivers in excess of $1 million have been granted with respect to a plan maintained by any member of the controlled group and any portion of the waived amount is still outstanding. Information provided to the PBGC in accordance with these requirements is not available to the public.

The PBGC may assess a penalty for a failure to provide the required information in the amount of up to $1,000 a day for each day the failure continues.[67]

Description of Proposal

The proposal revises the circumstances in which reporting of section 4010 information is required. Specifically, instead of requiring reporting if the aggregate unfunded vested benefits as of the end of the preceding plan year under all plans maintained by members of the controlled group exceed $50 million, the proposal requires reporting if: (1) the aggregate funding targets attainment percentage with respect to a controlled group for the preceding plan year is less than 60 percent; or (2) the aggregate funding targets attainment percentage with respect to a controlled group for the preceding plan year is less than 75 percent and the plan sponsor is in an industry with respect to which the PBGC determines that there is substantial unemployment or underemployment and the sales and profits are depressed or declining. The aggregate funding targets attainment percentage with respect to a controlled group for a plan year is the percentage, determined by taking into account all plans maintained by the members of the controlled group as of the end of the plan year, which: (1) the aggregate total of the values of plan assets, as of the end of the plan year, is of (2) the aggregate total of the funding targets of the plans, as of the end of the plan year, taking into account only vested benefits.

Under the proposal, any person submitting to the PBGC section 4010 information with respect to a plan must provide notice thereof within 90 days to participants and beneficiaries under the plan (and under all plans maintained by members of the controlled group of each

[66] ERISA sec. 4010.

[67] ERISA sec. 4071.

contributing sponsor of the plan). The notice must set forth: (1) the number of single-employer plans insured by the PBGC that are in at-risk status and maintained by contributing sponsors of the plan (and by members of their controlled groups) with respect to which the funding target attainment percentage for the preceding plan year is less than 60 percent; (2) the value of the assets of each plan for the plan year, the funding target for the plan year, and the funding target attainment percentage of each plan for the plan year and (3) taking into account all single-employer plans maintained by the contributing sponsor and the members of its controlled group, the aggregate total values of the assets of the plans as of the end of the plan year, the aggregate total of the funding targets of the plans (taking into account only vested benefits), and the aggregate funding targets attainment percentage (as defined above) with respect to the contributing sponsor for the preceding plan year.

For purposes of the notice requirement, a plan is in "at-risk status" for a plan year if the plan's funding target attainment percentage for the preceding year was less than 60 percent. A plan's "funding target attainment percentage" means the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to the special assumptions that apply to at-risk plans). A plan's funding target for a plan year is the present value of the liabilities to participants and beneficiaries under the plan.

Any notice required to be provided under the proposal may be provided in written, electronic, or other appropriate form to the extent such form is reasonably available to the persons to whom the information is required to be provided. A person is not entitled to receive more than one notice during any 12-month period. The person required to provide the notice may make a reasonable charge to cover copying, mailing, and other costs of furnishing the notice, subject to a maximum amount that may be prescribed by the PBGC.

Concurrent with the provision of notice as required under the proposal, notice must also be provided to the House Committees on Education and the Workforce and Ways and Means and the Senate Committees on Health, Education, Labor, and Pensions and Finance, which shall be treated as materials provided in executive session.

The present-law authority of the PBGC to impose a penalty for failure to provide section 4010 information applies to a failure to provide the notice required under the proposal.

Effective Date

The proposal is effective for plan years beginning after 2006.

VI. PROHIBITED TRANSACTION EXEMPTION FOR THE PROVISION OF INVESTMENT ADVICE

Present Law

ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person.[68] Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

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

Under ERISA, the Secretary of Labor may assess a civil penalty against a person who engages in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code. The penalty may not exceed five percent of the amount involved in the transaction for each year or part of a year that the prohibited transaction continues. If the prohibited transaction is not corrected within 90 days after notice from the Secretary of Labor, the penalty may be up to 100 percent of the amount involved in the transaction. Under the Code, if a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

Description of Proposal

The proposal adds a new category of prohibited transaction exemptions in connection with the provision of investment advice with respect to plan assets for a fee if: (1) the investment of plan assets is subject to the direction of plan participants or beneficiaries; (2) the

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[68] Code sec. 4975; ERISA sec. 406. Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities, as well as individual retirement accounts and annuities, Archer MSAs, health savings accounts, and Coverdell education savings accounts. The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans.

advice is provided to the plan or a participant or beneficiary by a fiduciary adviser in connection with a sale, acquisition or holding of a security or other property (an "investment transaction") for purposes of investment of plan assets; and (3) certain other requirements are met. Under the proposal, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice to the plan, participant or beneficiary; (2) an investment transaction (including any lending of money or other extension of credit associated with the investment transaction) pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation by a fiduciary adviser or an affiliate thereof (or any employee, agent or registered representative of the fiduciary adviser or an affiliate) in connection with the provision of the advice or an investment transaction pursuant to the advice.

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

The written notification required to be provided by the fiduciary adviser must include information about the following: (1) all fees or compensation to be received by the adviser or any affiliate (including from a third party) in connection with the advice or the investment transaction; (2) any material affiliation or contractual relationship of the adviser or its affiliates in the security or other property involved in the investment transaction; (3) any limitation to be placed on the scope of the investment advice to be provided by the fiduciary adviser with respect to an investment transaction; (4) the types of services provided by the adviser in connection with the provision of investment advice; (5) the adviser's status as a fiduciary of the plan in connection with the provision of the advice; and (6) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. In addition, in connection with the initial advice or subsequent advice, the required information must be maintained in currently accurate form and must be provided to a recipient of investment advice (without charge) at least annually and also when requested by the recipient of the advice or when there is a material change in the information. In the event of a material change in the information, currently accurate information must be provided to the recipient at a time reasonably contemporaneous to the change.

The written notification can be provided electronically. Any notification (or currently accurate information) must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and be sufficiently accurate and comprehensive so as to reasonably apprise participants and beneficiaries of the required information. The Secretary of Labor is directed to issue a model form for the disclosure of fees and other compensation as required by the proposal.

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

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

Subject to certain requirements, the employer or other person who is a plan fiduciary, other than a fiduciary adviser, is not treated as failing to meet the prohibited transaction requirements (or the fiduciary requirements of ERISA), solely by reason of the provision of investment advice as permitted under the proposal or of contracting for or otherwise arranging for the provision of the advice. This rule applies if: (1) the advice is provided under an arrangement between the employer or plan fiduciary and the fiduciary adviser for the provision of investment advice by the fiduciary adviser as permitted under the proposal; (2) the terms of the arrangement require compliance by the fiduciary adviser with the requirements of the proposal; and (3) the terms of the arrangement include a written acknowledgement by the fiduciary adviser that the fiduciary adviser is a plan fiduciary with respect to the provision of the advice. The fiduciary responsibility requirements of ERISA must also be met in connection with the provision of investment advice.

The proposal does not exempt the employer or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary adviser with whom the employer or plan fiduciary has arranged for the provision of investment advice. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary adviser.

The proposal also provides that nothing in the fiduciary responsibility provisions of ERISA is to be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

Effective Date

The proposal is effective with respect to investment advice provided on or after January 1, 2006.

VII. IMPROVEMENTS IN BENEFIT ACCRUAL STANDARDS

Present Law

Prohibition on age discrimination

In general

A prohibition on age discrimination applies to benefit accruals under a defined benefit pension plan.[69] Specifically, an employee's benefit accrual may not cease, and the rate of an employee's benefit accrual may not be reduced, because of the attainment of any age. However, this prohibition is not violated solely because the plan imposes (without regard to age) a limit on the amount of benefits that the plan provides or a limit on the number of years of service or years of participation that are taken into account for purposes of determining benefit accrual under the plan. Moreover, for purposes of this requirement, the subsidized portion of any early retirement benefit may be disregarded in determining benefit accruals.

In December 2002, the IRS issued proposed regulations that dealt with the application of the age discrimination rules.[70] Under the proposed regulations, for purposes of applying the prohibition on age discrimination to defined benefit pension plans, an employee's rate of benefit accrual for a year is generally the increase in the employee's accrued normal retirement benefit (i.e., the benefit payable at normal retirement age) for the plan year. In the preamble to the proposed regulations, the IRS requested comments on other approaches to determining the rate of benefit accrual, such as allowing accrual rates to be averaged over multiple years (for example, to accommodate plans that provide a higher rate of accrual in earlier years) or, in the case of a plan that applies an offset, determining accrual rates before application of the offset. As discussed below, in June 2004, the IRS announced the withdrawal of the proposed regulations.

Cash balance and other hybrid plans

Certain types of defined benefit pension plans, such as cash balance plans and pension equity plans, are referred to as "hybrid" plans because they combine features of a defined benefit pension plan and a defined contribution plan.

Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits"). Cash balance plans are generally designed so that, when a participant receives a pay credit for a year of service, the participant also receives the right to future interest on the pay credit, regardless of whether the participant continues employment (referred to as "front-loaded" interest credits).

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[69] Code sec. 411(b)(1)(H); ERISA sec. 204(b)(1)(H).

[70] 67 Fed. Reg. 76123.

That is, the participant's hypothetical account continues to be credited with interest after the participant stops working for the employer. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee's hypothetical account.

An age discrimination issue has arisen as a result of front-loaded interest credits under cash balance plans because there is a longer time for interest credits to accrue on pay credits to the account of a younger employee. A similar issue may arise with respect to other types of hybrid plans. Several court cases have considered whether front-loaded interest credits under cash balance plans violate the age discrimination rules and have reached inconsistent conclusions.[71]

The December 2002 proposed regulations provided a special rule under which an employee's rate of benefit accrual under a cash balance plan meeting certain requirements (an "eligible" cash balance plan) was based on the rate of pay credit provided under the plan. Thus, under the proposed regulations, an eligible cash balance plan would not violate the prohibition on age discrimination solely because pay credits for younger employees earn interest credits for a longer period. In June 2004, the IRS announced the withdrawal of the proposed age discrimination regulations, including the special rules for eligible cash balance plans.[72] According to the Announcement, "[t]his will provide Congress an opportunity to . . . address cash balance and other hybrid plan issues through legislation."

<u>Calculating minimum lump-sum distributions under hybrid plans</u>

Defined benefit pension plans, including cash balance plans and other hybrid plans, are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. If the plan permits benefits to be paid in certain other forms, such as a lump sum, minimum present value rules apply, under which the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.

Most cash balance plans are designed to permit a lump-sum distribution of a participant's hypothetical account balance upon termination of employment. As is the case with defined benefit pension plans generally, such a lump-sum amount is required to be not less than the present value of the benefit payable at normal retirement age, determined using the statutory interest and mortality assumptions.[73] A participant's normal retirement benefit under a cash

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[71] *Tootle v. ARINC Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Cooper v. IBM Personal Pension Plan*, 274 F. Supp. 2d 1010 (S.D. Ill. 2003); *Eaton v. Onan*, 117 F. Supp. 2d 812 (S.D. Ind. 2000).

[72] IRS Announcement 2004-57, 2004-27 I.R.B. 15.

[73] *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), cert. dismissed, 531 U.S. 1061 (2001); *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000), cert. denied, 532 U.S. 967 (2001); *West v. AK Steel Corp. Retirement Accumulation Plan*, 318 F. Supp.2d 579 (S.D. Ohio 2004); Notice 96-8, 1996-1996-1 C.B. 359. Additionally, under *Esden*, if participants accrue interest

balance plan is generally determined by projecting the participant's hypothetical account balance to normal retirement age by crediting to the account future interest credits, the right to which has already accrued, and converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan.

A difference in the rate of interest credits provided under the plan, which is used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit will cause a discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-sum amount will generally be greater than the hypothetical account balance.[74]

Description of Proposal

Age discrimination rules

Under the proposal, a plan is not treated as violating the prohibition on age discrimination if a participant's entire accrued benefit, as determined as of any date under the formula for determining benefits as set forth in the text of the plan documents, would be equal to or greater than that of any similarly situated, younger individual. For this purpose, an individual is similarly situated to a participant if the individual is identical to the participant in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age. In addition, in determining a participant's entire accrued benefit for this purpose, the subsidized portion of any early retirement benefit (including any early retirement subsidy that is fully or partially included or reflected in an employee's opening balance or other transition benefits) is disregarded.

In addition, under the proposal, plans do not violate the prohibition on age discrimination solely because of the following plan designs or features:

1. A plan under which the accrued benefit payable under the plan upon distribution (or any portion thereof) is expressed as the balance of a hypothetical account maintained for the participant is not treated as violating the prohibition on age discrimination solely because interest accruing on the account balance is taken into account.

2. A plan is not treated as violating the prohibition on age discrimination solely because, under the plan, benefits attributable to employer contributions may be offset by:

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credits under a cash balance plan at an interest rate that is higher than the interest assumptions prescribed by the Code for determining the present value of the annuity, the interest credits must be reflected in the projection of the participant's hypothetical account balance to normal retirement age in order to avoid violating the Code's prohibition against forfeitures.

[74] This result is sometimes referred to as "whipsaw."

(1) Social Security or Railroad Retirement benefits; (2) benefits under another qualified retirement plan of the same employer; or (3) benefits under a retirement program for officers or employees of the Federal Government or a State or local government. For this purpose, allowable offsets based on such benefits may consist of offsets equal to all or part of the actual benefit payment amounts, reasonable projections or estimations of such benefit payment amounts, or actuarial equivalents of such actual benefit payment amounts, projections, or estimations (determined on the basis of reasonable actuarial assumptions).

3. A plan is not treated as violating the prohibition on age discrimination solely because the plan provides for disparity in contributions or benefits with respect to which the permitted disparity requirements are met.

4. A plan is not treated as violating the prohibition on age discrimination solely because the plan provides for pre-retirement indexing of accrued benefits under the plan. For this purpose, the term "pre-retirement indexing" means, in connection with an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized index or methodology so as to protect the economic value of the benefit against inflation before distribution.

Calculating minimum lump-sum distributions under hybrid plans

The proposal provides a special rule for determining minimum lump-sum benefits under a defined benefit pension plan under which the accrued benefit payable upon distribution (or any portion thereof) is expressed as the balance of a hypothetical account maintained for the participant. Under the proposal, such a plan is not treated as violating the minimum present value rules solely because of the amount actually made available for distribution under the terms of the plan, in any case in which the applicable interest rate that would be used under the terms of the plan to project the amount of the participant's account balance to normal retirement age is not greater than a market rate of return. The Secretary of the Treasury is given regulatory authority relating to: (1) the calculation of a market rate of return for this purpose; and (2) permissible methods of crediting interest to the account (including variable interest rates) resulting in effective rates of return not greater than a market rate of return.

Effective Date

The proposal is effective for periods beginning on or after June 29, 2005.

VIII. DEDUCTION LIMITATIONS

A. Increase in Deduction Limits

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

In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.[76] The maximum amount otherwise deductible generally is not less than the plan's unfunded current liability.[77] In the case of a single-employer plan covered by the PBGC insurance program that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of plan termination under the PBGC insurance program.

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

If an employer sponsors one or more defined benefit pension plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year. The overall deduction limit generally is the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year, but not less than the amount of the plan's unfunded current liability.

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.

<u>Description of Proposal</u>

The proposal modifies the maximum deductible amount in the case of both single-employer defined benefit pension plans and multiemployer defined benefit pension plans.

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[75] Code sec. 404.

[76] The full funding limitation is the excess, if any, of (1) the accrued liability of the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets. However, the full funding limit is not less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets.

[77] In the case of a plan with 100 or fewer participants, unfunded current liability for this purpose does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

In the case of a single-employer defined benefit pension plan, the maximum deductible amount is equal to the greater of:

1. the excess (if any) of the sum of 150 percent of the plan's funding target plus the normal cost for the plan year over the value of plan assets (determined as under the minimum funding rules), and

2. the excess (if any) of the sum of the plan's at-risk normal cost and at-risk funding target for the plan year over the value of the plan assets (determined as under the minimum funding rules). For this purpose, the at-risk funding target and at-risk normal cost are used regardless of whether the plan is in fact in at-risk status.

In determining the maximum deductible amount, the value of plan assets is not reduced by any pre-funding balance or funding standard account carryover balance.

The proposal retains the present-law rule, that, in the case of a single-employer plan covered by the PBGC that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

In the case of a multiemployer defined benefit plan, the maximum amount deductible is not less than 140 percent of current liability over the value of plan assets.

Effective Date

The proposal is effective for contributions for taxable years beginning after December 31, 2006.

B. Updating Deduction Rules for Combination of Plans

Present Law

Employer contributions to qualified retirement plans are deductible subject to certain limits.[78] In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan, the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.[79] The maximum amount otherwise deductible generally is not less than the plan's unfunded current liability.[80] In the case of a single-employer plan covered by the PBGC insurance program that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of plan termination under the PBGC insurance program.

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

If an employer sponsors one or more defined benefit pension plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year. The overall deduction limit generally is the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirements of the defined benefit plan for the year, but not less than the amount of the plan's unfunded current liability.

Under EGTRRA, elective deferrals are not subject to the limits on deductions and are not taken into account in applying the limits to other employer contributions. The combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.[81]

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[78] Code sec. 404.

[79] The full funding limitation is the excess, if any, of (1) the accrued liability of the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets. However, the full funding limit is not less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets.

[80] In the case of a plan with 100 or fewer participants, unfunded current liability for this purpose does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

[81] Under the general EGTRRA sunset, this rule expires for plan years beginning after 2010.

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

Description of Proposal

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

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

Effective Date

The proposal is effective for contributions for taxable years beginning after December 31, 2006.

IX. ENHANCED RETIREMENT SAVINGS AND DEFINED CONTRIBUTION PLANS

A. Permanency of EGTRRA Pension and IRA Provisions

Present Law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the Federal tax laws, including a variety of provisions relating to pensions and individual retirement arrangements ("IRAs"). However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974 (e.g., section 313 of the Budget Act, under which a point of order may be lodged in the Senate), EGTRRA included a "sunset" provision, pursuant to which the provisions of EGTRRA expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, both the Internal Revenue Code and the Employee Retirement Income Security Act of 1974 ("ERISA") will be applied as though EGTRRA had never been enacted.

Certain provisions contained in EGTRRA expire before the general sunset date of 2010.[82]

Description of Proposal

The proposal repeals the sunset provision of EGTRRA as applied to the provisions relating to pensions and IRAs.

Effective Date

The proposal is effective on the date of enactment.

[82] The saver's credit (sec. 25B) expires at the end of 2006. Another provision of the proposal makes the saver's credit permanent.

B. Saver's Credit Made Permanent

Present Law

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. 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 are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

The credit is available with respect to: (1) elective deferrals to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity (a "section 403(b)" annuity), an eligible deferred compensation arrangement of a State or local government (a "section 457 plan"), a SIMPLE, or a simplified employee pension ("SEP"); (2) contributions to a traditional or Roth IRA; and (3) voluntary after-tax employee contributions to a tax sheltered annuity or qualified retirement plan.

The amount of any contribution eligible for the credit is reduced by distributions received by the taxpayer (or by the taxpayer's spouse if the taxpayer filed a joint return with the spouse) from any plan or IRA to which eligible contributions can be made 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 for which the credit is claimed and prior to the due date for filing the taxpayer's return for the year. Distributions that are rolled over to another retirement plan do not affect the credit.

The credit rates based on AGI are provided in Table 1, below.

Table 1. Credit Rates for Saver's Credit

Joint Filers	Heads of Households	All Other Filers	Credit Rate
$0-$30,000	$0-$22,500	$0-$15,000	50 percent
$30,001-$32,500	$22,501-$24,375	$15,001-$16,250	20 percent
$32,501-$50,000	$24,376-$37,500	$16,251-$25,000	10 percent
Over $50,000	Over $37,500	Over $25,000	0 percent

The credit does not apply to taxable years beginning after December 31, 2006.

Description of Proposal

The proposal makes the saver's credit permanent.

Effective Date

The proposal is effective on the date of enactment.

C. Increasing Participation Through Automatic Enrollment Arrangements

Present Law

Qualified cash or deferred arrangements--in general[83]

Under present law, most defined contribution plans may include a qualified cash or deferred arrangement (commonly referred to as a "section 401(k)" or "401(k)" plan),[84] under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as "elective deferrals" or "elective contributions".[85] A 401(k) plan may be designed so that the employee will receive cash unless an affirmative election to make contributions is made. Alternatively, a plan may provide that elective contributions are made at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate). Arrangements that operate in this manner are sometimes referred to as "automatic enrollment" or "negative election" plans. In either case, the employee must have an effective opportunity to elect to receive cash in lieu of contributions.[86]

Nondiscrimination rules

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the "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

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[83] Tax-sheltered annuities (section 403(b) annuities) may provide for contributions on a salary reduction basis, similar to section 401(k) plans. Matching contributions under a section 403(b) annuity are subject to the same nondiscrimination rules under section 401(m) as matching contributions under a section 401(k) plan (sec. 403(b)(12)). Thus, for example, the safe harbor method of satisfying the section 401(m) rules for matching contributions under a 401(k) plan applies to section 403(b) annuities.

[84] Legally, a section 401(k) plan is not a separate type of plan, but is a profit-sharing, stock bonus, or pre-ERISA money purchase plan that contains a qualified cash or deferred arrangement. The terms "section 401(k) plan" and "401(k) plan" are used here for convenience.

[85] The maximum annual amount of elective deferrals that can be made by an individual is subject to a limit ($14,000 for 2005). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan, subject to a limit ($4,000 for 2005).

[86] Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. Treas. Reg. sec. 1.401(k)-1(e)(2).

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 two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a "safe harbor section 401(k) plan"). A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. A plan generally 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 three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. In addition, the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee cannot be greater than the rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.

Employer matching contributions are also subject to a special nondiscrimination test, the "ACP test," which compares the average actual contribution percentages ("ACPs") of matching contributions for the highly compensated employee group and the nonhighly compensated employee group. 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 two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

A safe harbor section 401(k) plan that provides for matching contributions is deemed to satisfy the ACP test if, in addition to meeting the safe harbor contribution and notice requirements under section 401(k), (1) matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (3) the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee.

Top-heavy rules

Special rules apply in the case of a top-heavy plan. In general, a defined contribution plan is a top-heavy plan if the accounts of key employees account for more than 60 percent of the aggregate value of accounts under the plan. If a plan is a top-heavy plan, then certain minimum vesting standards and minimum contribution requirements apply.

A plan that consists solely of contributions that satisfy the safe harbor plan rules for elective and matching contributions is not considered a top-heavy plan.

ERISA provisions

Fiduciary rules

ERISA contains general fiduciary standards[87] that apply to all fiduciary actions, including investment decisions with respect to plan assets. Plan fiduciaries may be held personally liable for breaches of fiduciary duty.

A defined contribution plan may permit participants and beneficiaries to make investment decisions with respect to their individual accounts. For example, it is common for 401(k) plans to provide participants with investment authority with respect to their own elective contributions. Under a safe harbor rule, ERISA fiduciary liability does not apply to investment decisions made by plan participants if plan participants control the investment of their individual accounts. If the safe harbor applies, a plan fiduciary may be liable for the investment alternatives made available, but not for the specific investment decisions of participants. Department of Labor regulations provide detail as to the requirements that must be satisfied for the safe harbor to apply, for example, the number and type of investment options that must be available, the information that must be provided to plan participants, and the frequency with which participants must be allowed to give investment instructions. The safe harbor is often referred to as the "404(c) safe harbor" after the section of ERISA which contains the rule. According to the Department of Labor, a participant or beneficiary is not considered to have exercised control if the participant or beneficiary is merely apprised of investments that will be made on his or her behalf in the absence of instructions to the contrary.

[87] ERISA requires that a plan fiduciary must discharge his or her duties solely in the interest of participants and beneficiaries and: (1) for the exclusive purpose of providing benefits to plan participants and beneficiaries and defraying reasonable expenses of plan administration; (2) with the care, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims; by diversifying the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not do to so; and in accordance with plan documents insofar as they are consistent with ERISA.

Preemption

Subject to certain exceptions, ERISA preempts any and all State laws relating to any employee benefit plan, other than any generally applicable State criminal law.

Description of Proposal

In general

Under the proposal, a 401(k) plan that contains an automatic enrollment feature that satisfies certain requirements (a "qualified automatic enrollment feature") is treated as meeting the ADP test with respect to elective deferrals and the ACP test with respect to matching contributions.[88] In addition, a plan consisting solely of contributions made pursuant to a qualified automatic enrollment feature is not subject to the top-heavy rules.

A qualified automatic enrollment feature must meet certain requirements with respect to: (1) automatic deferral; (2) participation; (3) matching or nonelective contributions; and (4) notice to employees.

Automatic deferral

A qualified automatic enrollment feature must provide that, unless an employee elects otherwise, the employee is treated as making an election to make elective deferrals equal to a stated percentage of compensation not in excess of 10 percent and at least equal to: three percent of compensation for the first year the deemed election applies to the participant; four percent during the second year; five percent during the third year; and six percent during the fourth year and thereafter. The stated percentage must be applied uniformly to all eligible employees. Eligible employees mean all employees eligible to participate in the 401(k) plan, other than employees eligible to participate in the 401(k) plan immediately before the date on which the qualified automatic enrollment arrangement (or a predecessor) is adopted. Thus, for example, if an employer has a pre-existing 401(k) plan for which all employees are eligible, the automatic enrollment feature would be required to cover newly hired employees.

Participation requirement

An automatic enrollment feature satisfies the participation requirement for a year if, for the plan year or the immediately preceding plan year, elective deferrals are made on behalf of at least 70 percent of the employees eligible under the automatic enrollment arrangement other than highly compensated employees and employees who were eligible to participate in the 401(k) plan immediately before the qualified automatic enrollment arrangement is effective. The participation requirement is deemed to be satisfied for the first year the qualified automatic enrollment feature is in effect.

[88] Similarly, the new safe harbor applies with respect to matching contributions under a section 403(b) annuity through the operation of section 403(b)(12).

Matching or nonelective contribution requirement

Contributions

An automatic enrollment feature satisfies the contribution requirement if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least two percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the automatic enrollment feature. A plan generally 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 50 percent of the employee's elective deferrals as do not exceed six percent of compensation and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Alternatively, matching contributions satisfy the requirement in (1) if the rate of match does not increase as an employee's rate of elective contributions increases and the aggregate amount of matching contributions at such rate of elective contributions is at least equal to the aggregate amount of matching contributions which would be made if matching contributions were made on the basis of the percentage described in (1). The matching contributions may be made to the plan of which the automatic enrollment arrangement is a part or to another plan of the employer.

A plan including an automatic enrollment feature that provides for matching contributions is deemed to satisfy the ACP test if, in addition to meeting the safe harbor contribution requirements applicable to the qualified automatic enrollment feature: (1) matching contributions are not provided with respect to elective deferrals in excess of six percent of compensation, (2) the rate of matching contribution does not increase as the rate of an employee's elective deferrals increases, and (3) the rate of matching contribution with respect to any rate of elective deferral of a highly compensated employee is no greater than the rate of matching contribution with respect to the same rate of deferral of a nonhighly compensated employee.

Vesting

Any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic enrollment feature are satisfied must vest at least as rapidly as under two-year cliff vesting. That is, employees with at least two years of service must be 100 percent vested with respect to such contributions.

Withdrawal restrictions

Any matching or other employer contributions taken into account in determining whether the requirements for a qualified automatic enrollment feature are satisfied are subject to the withdrawal rules applicable to elective contributions.

Notice requirement

Under the notice requirement, each employee covered by the arrangement must receive notice of the arrangement which is sufficiently accurate and comprehensive to apprise the employee of such rights and obligation and is written in a manner calculated to be understood by the average employee to whom the arrangement applies.[89] The notice must explain: (1) the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to elect to have contributions made in a different amount; and how contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is to be made to make an election with respect to contributions and investments.

Corrective distributions

The proposal includes rules under which erroneous automatic contributions may be distributed from the plan, including a waiver of the 10-percent early withdrawal tax.

Application to tax-sheltered annuities

Rules similar to the automatic contribution rules apply to matching contributions under tax-sheltered annuities (sec. 403(b)).

Effective Date

The proposal is effective for years beginning after December 31, 2005.

[89] Employees who are not required to be covered by the qualified automatic enrollment feature, i.e., employees previously covered under the 401(k) plan, are required to receive the notice if they are covered by the automatic enrollment feature.

D. Treatment of Distributions to Guardsmen Called to Active Duty

Present Law

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

Certain amounts held in a 401(k) plan or in a 403(b) annuity may not be distributed before severance from employment, age 59-½, death, disability, or financial hardship of the employee.

Description of Proposal

Under the proposal, the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") or similar arrangement, (2) made to an individual who (by reason of being a member of a reserve component) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A 401(k) plan or tax-sheltered annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not apply to any contribution made pursuant to the proposal. No deduction is allowed for any contribution made under the proposal.

This proposal applies to individuals ordered or called to active duty after September 11, 2001, and before September 12, 2007. The two-year period for making recontributions of qualified reservist distributed does not end before the date that is two years after the date of enactment.

Effective Date

The proposal applies to distributions after September 11, 2001.

If refund or credit of any overpayment of tax resulting from the proposal would be prevented at any time before the close of the one-year period beginning on the date of the enactment by the operation of any law or rule of law (including res judicata), such refund or credit may nevertheless be made or allowed if claim therefor is filed before the close of such period.

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

Present Law

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

Description of Proposal

Under the proposal, the 10-percent early withdrawal tax does not apply to distributions to a qualified safety employee from a governmental plan to the extent that such distributions are attributable to a deferred retirement option plan or "DROP" benefit. A DROP benefit is a feature of a governmental defined benefit plan under which an employee elects to receive credits to an account (including a notional account) in the plan which are not in excess of the plan benefits that would have been provided if the employee had retired under the plan at a specified earlier retirement date and which are in lieu of increases in the employee's accrued pension benefit under such defined benefit plan based on years of service after the effective date of the DROP election. The waiver of the penalty is available only to amounts that would have been payable as an annuity from the defined benefit plan had the individual retired and taken the defined benefit plan benefit.

A qualified public safety employee is an employee of any police department or fire department organized and operated by a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision and would have been eligible to retire on or before the effective date of the DROP election and receive an immediate retirement benefit under the defined benefit plan.

Effective Date

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

F. Combat Zone Compensation Taken into Account for Purposes of IRA Contributions

Present Law

There are two general types of individual retirement arrangements (“IRAs”): traditional IRAs and Roth IRAs. The total amount that an individual may contribute to one or more IRAs for a year is generally limited to the lesser of: (1) a dollar amount ($4,000 for 2005); and (2) the amount of the individual's compensation that is includible in gross income for the year. In the case of an individual who has attained age 50 before the end of the year, the dollar amount is increased by an additional amount ($500 for 2005). In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses that is includible in gross income is at least equal to the contributed amount. IRA contributions in excess of the applicable limit are generally subject to an excise tax of six percent per year until withdrawn.

An individual may make contributions to a traditional IRA (up to the contribution limit) without regard to his or her adjusted gross income. An individual may deduct his or her contributions to a traditional IRA if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan. If an individual or the individual’s spouse is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels.

Individuals with adjusted gross income below certain levels may make contributions to a Roth IRA (up to the contribution limit). Contributions to a Roth IRA are not deductible.

Present law provides an exclusion from gross income for combat pay received by members of the Armed Forces. Thus, combat pay is not includible compensation for purposes of applying the limit on IRA contributions.

Description of Proposal

Under the proposal, for purposes of applying the limit on IRA contributions, an individual's gross income is determined without regard to the exclusion for combat pay. Thus, combat pay received by an individual is treated as includible compensation for purposes of determining the amount that the individual (and the individual's spouse) can contribute to an IRA.

Effective Date

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

G. Direct Deposit of Tax Refunds in an IRA

Present Law

Rules relating to individual retirement arrangements ("IRAs")

In general

Present law provides tax-favored savings through traditional and Roth IRAs. Contributions to a traditional or Roth IRA for a year may be made by the due date for the tax return for the year (determined without regard to extensions).

Traditional IRAs

Under present law, an individual may generally make deductible contributions to a traditional IRA for a taxable year up to the lesser of a dollar amount ($4,000 for 2005) or the individual's taxable compensation for the year.[90] A contribution of up to the dollar limit for each spouse may be made to a traditional IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The amount of contributions that can be made to a traditional IRA is reduced to the extent the individual makes contributions to a Roth IRA.

If an individual is an active participant in an employer-sponsored retirement plan, the maximum IRA deduction limit is phased out over certain levels of modified adjusted gross income. In the case of a married taxpayer filing a joint return, the phase-out range is: $70,000 to $80,000 of modified adjusted gross income for 2005; $75,000 to $85,000 of modified adjusted gross income for 2006; and $80,000 to $100,000 of modified adjusted gross income for 2007 and thereafter.[91]

In the case of single taxpayers who are active participants in an employer-sponsored retirement plan, the phase-out range is $50,000 to $60,000 of modified adjusted gross income in 2005 and thereafter.

If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the maximum IRA deduction limit is phased out for modified adjusted gross income of $150,000 to $160,000.

An individual may make nondeductible contributions to a traditional IRA to the extent the individual does not or may not make deductible contributions.

Distributions from a traditional IRA are includible in gross income to the extent they represent the return of nondeductible contributions. Subject to certain exceptions, if the

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[90] The dollar limit is increased for individuals who are age 50 or older.

[91] The income phase-out range for a married taxpayer who is an active participant and who files a joint return is $0 to $10,000 of modified adjusted gross income.

distribution is made prior to age 59-1/2, death, or disability, a 10-percent additional early withdrawal tax applies to the taxable amount of a distribution.

Roth IRAs

Individuals with modified adjusted gross income 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 a dollar limit ($4,000 for 2005) or the individual's taxable compensation for the year.[92] The contribution limit is reduced to the extent an individual makes contributions (deductible or nondeductible) to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to the dollar limit 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 modified adjusted gross income between $95,000 and $110,000 and for married taxpayers filing joint returns with modified adjusted gross income between $150,000 and $160,000.[93]

Taxpayers with modified adjusted gross income 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) 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. Subject to certain exceptions, if the distribution is made prior to age 59-1/2, death, or disability, a 10-percent additional early withdrawal tax applies to the taxable amount of a distribution, and subject to the 10-percent early withdrawal tax (unless an exception applies).

Direct deposit of tax refunds

Under current IRS procedures, a taxpayer may direct that his or her tax refund be deposited into a checking or savings account with a bank or other financial institution (such as a

[92] The dollar limit is increased for individuals who are age 50 or older.

[93] In the case of a married taxpayer filing a separate return, the income phaseout range is $0 to $10,000 of modified adjusted gross income.

mutual fund, brokerage firm, or credit union) rather than having the refund sent to the taxpayer in the form of a check.

Description of Proposal

The Secretary is directed to develop forms under which all or a portion of a taxpayer's refund may be deposited in an IRA of the taxpayer (or the spouse of the taxpayer in the case of a joint return). The proposal does not modify the rules relating to IRAs, including the rules relating to timing of contributions.

Effective Date

The form required by the proposal is to be available for taxable years beginning after December 31, 2006.

X. PROVISIONS TO ENHANCE HEALTH CARE AFFORDABILITY

A. Tax Treatment of Combined Annuity and Life Insurance Contracts with a Long-Term Care Insurance Feature

Present Law

Annuity contracts

In general, earnings and gains on amounts invested in a deferred annuity contract are not subject to tax during the deferral period in the hands of the holder of the contract. When payout commences under a deferred annuity contract, the tax treatment of amounts distributed depends on whether the amount is received "as an annuity" (generally, as periodic payments under contract terms) or not.

For amounts received as an annuity by an individual, an "exclusion ratio" is provided for determining the taxable portion of each payment (sec. 72(b)). The portion of each payment that is attributable to recovery of the taxpayer's investment in the contract is not taxed. The taxable portion of each payment is ordinary income. The exclusion ratio is the ratio of the taxpayer's investment in the contract to the expected return under the contract, that is, the total of the payments expected to be received under the contract. The ratio is determined as of the taxpayer's annuity starting date. Once the taxpayer has recovered his or her investment in the contract, all further payments are included in income. If the taxpayer dies before the full investment in the contract is recovered, a deduction is allowed on the final return for the remaining investment in the contract (sec. 72(b)(3)).

Amounts not received as an annuity generally are included as ordinary income if received on or after the annuity starting date. Amounts not received as an annuity are included in income to the extent allocable to income on the contract if received before the annuity starting date, i.e., as income first (sec. 72(e)(2)). In general, loans under the annuity contract, partial withdrawals and partial surrenders are treated as amounts not received as an annuity and are subject to tax as income first (sec. 72(e)(4)). Exceptions are provided in some circumstances, such as for certain grandfathered contracts, certain life insurance and endowment contracts (other than modified endowment contracts), and contracts under qualified plans (sec. 72(e)(5)). Under these exceptions, the amount received is included in income, but only to the extent it exceeds the investment in the contract, i.e., as basis recovery first.

Long-term care insurance contracts

Tax treatment

Present law provides favorable tax treatment for qualified long-term care insurance contracts meeting the requirements of section 7702B.

A qualified long-term care insurance contract is treated as an accident and health insurance contract (sec. 7702B(a)(1)). Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness (sec. 104(a)(3)). The excludable amount is subject to a dollar cap of $175 per day or $63,875 annually (for 1997), as indexed, on per diem contracts only (sec. 7702B(d)). If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis under section 72.

A plan of an employer providing coverage under a long-term care insurance contract generally is treated as an accident and health plan (benefits under which generally are excludable from the recipient's income under section 105).

Premiums paid for a qualified long-term care insurance contract are deductible as medical expenses, subject to a dollar cap on the deductible amount of the premium per year based on the insured person's age at the end of the taxable year (sec. 213(d)(10)). Medical expenses generally are allowed as a deduction only to the extent they exceed 7.5 percent of adjusted gross income (sec. 213(a)).

Unreimbursed expenses for qualified long-term care services provided to the taxpayer or the taxpayer's spouse or dependent are treated as medical expenses for purposes of the itemized deduction for medical expenses (subject to the floor of 7.5 percent of adjusted gross income). Amounts received under a qualified long-term care insurance contract (regardless of whether the contract reimburses expenses or pays benefits on a per diem or other periodic basis) are treated as reimbursement for expense actually incurred for medical care (sec. 7702B(a)(2)).

Definitions

A qualified long-term care insurance contract is defined as any insurance contract that provides only coverage of qualified long-term care services, and that meets additional requirements (sec. 7702B(b)). The contract is not permitted to provide for a cash surrender value or other money that can paid, assigned or pledged as collateral for a loan, or borrowed (and premium refunds are to be applied as a reduction in future premiums or to increase future benefits). Per diem-type and reimbursement-type contracts are permitted.

Qualified long-term care services are necessary diagnostic, preventive, therapeutic, curing treating, mitigating, and rehabilitative services, and maintenance or personal care services that are required by a chronically ill individual and that are provided pursuant to a plan of care prescribed by a licensed health care practitioner (sec. 7702B(c)(1)).

A chronically ill individual is generally one who has been certified within the previous 12 months by a licensed health care practitioner as being unable to perform (without substantial assistance) at least 2 activities of daily (ADLs) for at least 90 days due to a loss of functional capacity (or meeting other definitional requirements) (sec. 7702B(c)(2)).

Long-term care riders on life insurance contracts

In the case of long-term care insurance coverage provided by a rider on or as part of a life insurance contract, the requirements applicable to long-term care insurance contracts apply as if the portion of the contract providing such coverage were a separate contract (sec. 7702B(e)). The term "portion" means only the terms and benefits that are in addition to the terms and benefits under the life insurance contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the contract's death benefit or cash surrender value.

The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract's cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)).

No medical expense deduction generally is allowed under section 213 for charges against the life insurance contract's cash surrender value, unless such charges are includible in income because the life insurance contract is treated as a "modified endowment contract" under section 72(e)(10) and 7702A (sec. 7702B(e)((3)).

Tax-free exchanges of insurance contracts

Present law provides for the exchange of certain insurance contracts without recognition of gain or loss (sec. 1035). No gain or loss is recognized on the exchange of: (1) a life insurance contract for another life insurance contract or for an endowment or annuity contract; or (2) an endowment contract for another endowment contract (that provides for regular payments beginning no later than under the exchanged contract) or for an annuity contract; or (3) an annuity contract for an annuity contract. The basis of the contract received in the exchange generally is the same as the basis of the contract exchanged (sec. 1031(d)). Tax-free exchanges of long-term care insurance contracts are not permitted.

Capitalization of certain policy acquisition expenses of insurance companies

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and are amortized generally over the 120-month period beginning with the first moth in the second half of the taxable year (sec. 848). Specified policy acquisition expenses are determined as that portion of the insurance company's general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7. With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof.

Description of Proposal

The proposal provides for the tax rules applicable to long-term care insurance that is provided by a rider on or as part of an annuity contract, and modifies the tax rules applicable to long-term care insurance coverage provided by a rider on or as part of a life insurance contract.

Under the proposal, any charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract made as payment for coverage under a qualified long-term care insurance contract that is part of or a rider on the annuity or life insurance contract is not includable in income. The investment in the contract is reduced (but not below zero) by the charge.

The proposal expands the rules for tax-free exchanges of certain insurance contracts. The proposal provides that no gain or loss is recognized on the exchange of a life insurance contract, an endowment contract, an annuity contract, or a qualified long-term care insurance contract for a qualified long-term care insurance contract. The proposal provides that a contract does not fail to be treated as an annuity contract, or as a life insurance contract, solely because a qualified long-term care insurance contract is a part of or a rider on such contract, for purposes of the rules for tax-free exchanges of certain life insurance contracts.

The proposal provides that, except as otherwise provided in regulations, for Federal tax purposes, in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract.

No deduction as a medical expense is allowed for any payment made for coverage under a qualified long-term care insurance contract if the payment is made as a charge against the cash value of an annuity contract or the cash surrender value of a life insurance contract.

For purposes of the definition of a life insurance contract, the guideline premium limitation is increased by charges against the contract's cash surrender value for coverage under the qualified long-term care insurance contract (reduced by charges that reduce the premiums paid for the life insurance contract).

The proposal provides that certain retirement-related arrangements are not treated as annuity contracts, for purposes of the proposal.

The proposal requires information reporting by any person who makes a charge against the cash value of an annuity contract, or the cash surrender value of a life insurance contract, that is excludible from gross income under the proposal. The information required to be reported includes the amount of the aggregate of such charges against each such contract for the calendar year, the amount of the reduction in the investment in the contract by reason of the charges, and the name, address, and taxpayer identification number of the holder of the contract.

The proposal modifies the application of the rules relating to capitalization of policy acquisition expenses of insurance companies. In the case of an annuity or life insurance contract that includes a qualified long-term care insurance contract as a part of or rider on the annuity or life insurance contract, the specified policy acquisition expenses that must be capitalized is determined using 7.7 percent of the net premiums for the taxable year on such contracts.

The proposal increases the amount of pre-funding permitted by treating qualified long-term care insurance coverage under the rider as a qualified additional benefit, for purposes of the present-law definition of a life insurance contract.

Effective Date

The proposal is generally effective for contracts issued before, on, or after December 31, 2006, but only with respect to periods beginning after that date. The proposal expanding the rules for tax-free exchanges of certain insurance contracts applies with respect to exchanges occurring after December 31, 2006.

B. Disposition of Unused Health Benefits in Flexible Spending Arrangements

Present Law

Flexible spending arrangements

A flexible spending arrangement ("FSA") is a reimbursement account or other arrangement under which an employee is reimbursed for medical expenses or other nontaxable employer-provided benefits, such as dependent care. Typically, FSAs are part of a cafeteria plan and may be funded through salary reduction. FSAs may also be provided by an employer outside of a cafeteria plan. FSAs are commonly used, for example, to reimburse employees for medical expenses not covered by insurance.

There is no special exclusion for benefits provided under an FSA. Thus, benefits provided under an FSA are excludable from income only if there is a specific exclusion for the benefits in the Code (e.g., the exclusion for employer-provided health care (other than long-term care) or dependant care assistance coverage). If certain requirements are satisfied, contributions to a health FSA and all distributions to pay medical expenses are excludable from income and from wages for FICA tax purposes.

FSAs that are part of a cafeteria plan must comply with the rules applicable to cafeteria plans generally. One of these rules is that a cafeteria plan may not offer deferred compensation except through a qualified cash or deferred arrangement.[94] Under proposed Treasury regulations, a cafeteria plan is considered to permit the deferral of compensation if it includes a health FSA which reimburses participants for medical expenses incurred beyond the end of the plan year.[95] Thus, amounts in an employee's account that are not used for medical expenses incurred before the end of a plan year must be forfeited. This rule is often referred to as the "use it or lose it" rule. The IRS recently issued guidance allowing a grace period immediately following the end of a plan year during which unused benefits or contributions remaining at the end of the plan year may be paid or reimbursed to plan participants for qualified benefit expenses incurred during a grace period.[96] A plan may allow benefits not used during the plan year to be used to reimburse qualified expenses incurred during the period, not to exceed two and one-half months, immediately following the end of the plan year.

Proposed Treasury regulations contain additional requirements with which health FSAs must comply in order for the coverage and benefits provided under the FSA to be excludable from income.[97] These rules apply with respect to a health FSA without regard to whether the

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[94] Sec. 401(k).

[95] Prop. Treas. Reg. 1.125-2 Q&A-5(a).

[96] Notice 2005-42.

[97] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

health FSA is provided through a cafeteria plan (i.e., without regard to whether an employee has an election to take cash or benefits).

The proposed regulations define a health FSA as a benefit program that provides employees with coverage under which specified, incurred expenses may be reimbursed (subject to reimbursement maximums and any other reasonable conditions) and under which the maximum amount of reimbursement that is available to a participant for a period of coverage is not substantially in excess of the total premium (including both employee-paid and employer-paid portions of the premium) for such participant's coverage. A maximum amount of reimbursement is not substantially in excess of the total premium if the maximum amount is less than 500 percent of the premium.[98]

Under the proposed regulations, the employer-provided health coverage under the FSA and the reimbursements and other benefits received under the health FSA are excludable from an employee's income only if the health FSA satisfies certain additional requirements. According to the proposed regulations, health FSAs are required to: (1) provide the maximum amount of reimbursement available under the FSA at all times during the period of coverage (properly reduced as of any particular time for prior reimbursements for the same period of coverage); (2) offer coverage for 12 months or, in the case of a short plan year, the entire short plan year; (3) only reimburse medical expenses which meet the definition of medical care under section 213(d); (4) reimburse medical expenses for which the participant provides a written statement from an independent third party stating the amount of the medical expense and that the medical expense has not been reimbursed or is not reimbursable under any other health plan; (5) reimburse medical expenses which are incurred during the participant's period of coverage; and (6) allocate experience gains with respect to a year of coverage among premium payers on a reasonable and uniform basis.[99]

Health savings accounts

Present law provides that individuals with a high deductible health plan (and no other health plan other than a plan that provides certain permitted coverage) may establish a health savings account ("HSA").[100] An HSA is a tax-exempt trust or custodial account. Subject to certain limitations, contributions to an HSA are deductible above-the-line if made by the individual and are excludable from income and wages if made by the employer (including contributions made through a cafeteria plan through salary reduction). Earnings on amounts in an HSA accumulate on a tax-free basis. Distributions from an HSA that are for qualified medical expenses are excludable from gross income. Distributions from an HSA that are not used for qualified medical expenses are includible in gross income and are subject to an

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[98] Prop. Treas. Reg. 1.125-2 Q&A-7(c).

[99] Prop. Treas. Reg. 1.125-2 Q&A-7(b).

[100] Sec. 223. Revenue Ruling 2004-45 provides guidance on the extent to which individuals may make contributions to an HSA when also covered by a health FSA or a health reimbursement arrangement.

additional tax of 10 percent, unless the distribution is made after death, disability, or the individual attains the age of Medicare eligibility (i.e., age 65). HSAs provide the opportunity to pay for current out-of-pocket medical expenses on a tax-favored basis, as well as the ability to save for future medical and nonmedical expenses.

A high deductible health plan is a health plan that has a deductible that is at least $1,000 for self-only coverage or $2,000 for family coverage (for 2005) and that has an out-of-pocket expense limit that is no more than $5,100 in the case of self-only coverage and $10,200 in the case of family coverage (for 2005).

The maximum aggregate annual contribution that can be made to an HSA is the lesser of (1) 100 percent of the annual deductible under the high deductible health plan, or (2) for 2005, $2,650 in the case of self-only coverage and $5,250 in the case of family coverage.[101] The annual contribution limits are increased for individuals who have attained age 55 by the end of the taxable year. In the case of policyholders and covered spouses who are age 55 or older, the HSA annual contribution limit is greater than the otherwise applicable limit by $600 in 2005, $700 in 2006, $800 in 2007, $900 in 2008, and $1,000 in 2009 and thereafter.

Description of Proposal

The proposal allows up to $500 of unused health benefits in an employee's health FSA to be carried forward to the employee's health FSA for the next plan year. An employee's unused health benefit is the excess of the maximum amount of reimbursement allowable to the employee over the actual amount of reimbursement made during the year.

In the case of employees who are eligible individuals under the HSA rules (i.e., individuals who are covered under a high deductible health plan and no other health plan, other than certain permitted coverage) the proposal also allows up to $500 of unused health benefits in an employee's health FSA to be contributed on the employee's behalf to an HSA maintained for the benefit of the employee. Amounts contributed to an HSA are treated as employer contributions for purposes of the HSA rules, including the limits on contributions. As in the case of other amounts contributed to an HSA through a cafeteria plan, such amounts are not subject to the requirement that, in the case of employer contributions, comparable contributions must be made on behalf of all employees.

Effective Date

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

[101] These amounts are the same as the maximum deductible amounts permitted under a high deductible plan for purposes of Archer medical savings accounts ("MSAs").

C. Permit Tax-Free Distributions from Governmental Retirement Plans for Premiums for Health and Long-Term Care Insurance for Public Safety Officers

Present Law

Under present law, a distribution from a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity under section 403(b) (a "403(b) annuity"), an eligible deferred compensation plan maintained by a State or local government under section 457 (a "governmental 457 plan"), or an individual retirement arrangement under section 408 (an "IRA") generally is included in income for the year distributed (except to the extent the amount received constitutes a return of after-tax contributions or a qualified distribution from a Roth IRA).[102] In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59-½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies.[103]

Description of Proposal

The proposal provides that certain pension distributions from an eligible retirement plan used to pay for qualified health insurance premiums are excludible from income. An eligible retirement plan includes a governmental qualified retirement or annuity plan, 403(b) annuity, or 457 plan. The exclusion applies with respect to eligible retired public safety officers who make an election to have qualified health insurance premiums deducted from amounts distributed from an eligible retirement plan and paid directly to the insurer. An eligible retired public safety officer is an individual who, by reason of disability or attainment of normal retirement age, is separated from service as a public safety officer[104] with the employer who maintains the eligible retirement plan from which pension distributions are made.

Qualified health insurance premiums include premiums for accident or health insurance or qualified long-term care insurance contracts covering the taxpayer, the taxpayer's spouse, and the taxpayer's dependents. The qualified health insurance premiums do not have to be for a plan sponsored by the employer; however, the exclusion does not apply to premiums paid by the employee and reimbursed with pension distributions. The maximum amount that may be excluded in any year is $5,000. Amounts excluded from income under the proposal are not taken into account in determining the itemized deduction for medical expenses under section 213 or the deduction for health insurance of self-employed individuals under section 162.

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[102] Secs. 402(a), 403(a), 403(b), 408(d), and 457(a).

[103] Sec. 72(t).

[104] The term "public safety officer" has the same meaning as under section 1204(8)(A) of the Omnibus Crime Control and Safe Streets Act of 1986.

Effective Date

The proposal is effective for distributions made in taxable years beginning after December 31, 2005.