DESCRIPTION OF CHAIRMAN'S MODIFICATIONS TO THE "NATIONAL EMPLOYEE SAVINGS AND TRUST EQUITY GUARANTEE ACT"

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INTRODUCTION

The Senate Committee on Finance has scheduled a markup on July 11, 2002, of S. 1971, the "National Employee Savings and Trust Equity Guarantee Act." This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modifications to the "National Employee Savings and Trust Equity Guarantee Act."

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[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Modifications to the "National Employee Savings and Trust Equity Guarantee Act"* (JCX-74-02), July 9, 2002.

I. DIVERSIFICATION OF DEFINED CONTRIBUTION PLAN ASSETS

Present Law

In general

Qualified retirement plans are subject to regulation under the Internal Revenue Code (the "Code") and under the Employee Retirement Income Security Act of 1974 ("ERISA"). Some of the requirements under the Code and ERISA for qualified retirement plans are identical or very similar. For example, both the Code and ERISA impose minimum participation and vesting requirements. Other requirements are contained only in the Code or only in ERISA. In the case of a Code requirement, failure to satisfy the requirement could result in the loss of qualified status for the plan or in the imposition of an excise tax. In the case of an ERISA requirement, failure to satisfy the requirement could result in the imposition of a penalty or a civil action by a participant or the Department of Labor.

The Code and ERISA contain different rules that limit the investment of defined contribution plan assets in employer securities. The extent to which the limits apply depends on the type of plan and the type of contribution involved.

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

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in stock of the employer. An ESOP can be an entire plan or it can be a component of a larger defined contribution plan. An ESOP may provide for different types of contributions, including employer nonelective contributions and others. For example, an ESOP may include a 401(k) feature that permits employees to make elective deferrals.[2]

Under the Code,[3] ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities. The diversification requirement applies to a participant for six years, starting with the year in which the individual firsts meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

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

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

[3] All references are to provisions of the Code unless otherwise indicated.

(3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).[4]

10-percent limit on the acquisition of employer securities

The Employee Retirement Income Security Act of 1974 ("ERISA") prohibits money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer stock. This 10-percent limitation generally does not apply to other types of defined contribution plans.[5] Thus, most defined contribution plans, such as profit-sharing plans, stock bonus plans, and ESOPs, are not subject to any limit under ERISA on the amount of employer contributions that can be invested in employer securities. In addition, a fiduciary generally is deemed not to violate the requirement that plan assets be diversified with respect to the acquisition or holding of employer securities in such plans.[6]

Under ERISA, the 10-percent limitation on the acquisition of employer securities, described above, applies separately to the portion of a plan consisting of elective deferrals (and earnings thereon) if any portion of an individual's elective deferrals (or earnings thereon) are required to be invested in employer securities pursuant to plan terms or the direction of a person other than the participant. This restriction does not apply if (1) the amount of elective deferrals required to be invested in employer securities does not exceed more than one percent of any employee's compensation, (2) the fair market value of all defined contribution plans maintained by the employer is no more than 10-percent of the fair market value of all retirement plans of the employer, or (3) the plan is an ESOP.

Description of Proposal

In general

Under the proposal, in order to satisfy the requirements under the Code and under ERISA, certain defined contribution plans would be required to provide diversification rights with respect to amounts invested in employer securities. Such a plan would be required to permit applicable individuals to direct that the portion of the individual's account held in employer securities be invested in alternative investments. An applicable individual would include (1) any plan participant and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant. The time when

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[4] Sec. 401(a)(28); IRS Notice 88-56, 1988-1 C.B. 540, Q&A 16.

[5] The 10-percent limitation also applies to defined benefit plans and to a defined contribution plan that is part of an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

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

the diversification requirements apply would depend on the type of contributions invested in employer securities.

Plans subject to requirements

The diversification requirements would generally apply to any defined contribution plan holding publicly-traded employer securities (i.e, securities readily tradable on an established securities market). For this purpose, a plan holding employer securities that are not publicly traded would generally be treated as holding publicly-traded employer securities if the employer (or any member of the employer's controlled group) has issued any class of publicly-traded common stock. This treatment would not apply if (1) the employer (and any parent corporation of the employer) has not issued any class of publicly-traded stock or any special class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to an affiliate[7] of the employer that has issued any class of publicly-traded stock, and (2) the plan holds no stock of an affiliate of the employer that has issued any class of publicly-traded stock. The Secretary of Treasury would have the authority to provide other exceptions in regulations. For example, an exception could be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer's controlled group has issued a limited amount of publicly-traded stock.

The diversification requirements would not apply to an ESOP that (1) does not hold contributions (or earnings thereon) that are subject to the special nondiscrimination tests that apply to elective deferrals, employee after-tax contributions, and matching contributions, and (2) is maintained as a separate plan with respect to any other qualified retirement plan of the employer. Accordingly, an ESOP that holds elective deferrals, employee contributions, employer matching contributions, or nonelective employer contributions used to satisfy the special nondiscrimination tests (including the safe harbor methods of satisfying the tests) would be subject to the diversification requirements under the proposal. An ESOP that is subject to the diversification requirements under the proposal would no longer be subject to the present-law ESOP diversification rules.[8]

The diversification requirements under the proposal would not apply to a one-person plan. A one-person plan would be a plan that (1) on the first day of the plan year, covers only the employer (and the employer's spouse) and the employer owns the entire business (whether or

[7] For this purpose, "affiliate" would mean any corporation that is a member of the employer's controlled group as defined under section 1563(a), except that, in applying that section, 50 percent would be substituted for 80 percent, and "parent corporation" would mean any corporation (other than the employer) in an unbroken chain of corporations ending with the employer if each corporation other than the employer owns stock possessing at least 50 percent of the total combined voting power of all classes of stock with voting rights or at least 50 percent of the total value of shares of all classes of stock in one of the other corporations in the chain.

[8] Providing the diversification rights required under the proposal, or greater diversification rights, would not cause an ESOP to fail to be designed to invest primarily in qualifying employer securities under section 4975(e)(7)(A).

not incorporated) or covers only one or more partners (and their spouses) in a business partnership, (2) meets the minimum coverage requirements without being combined with any other plan that covers employees of the business, (3) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses), (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control, and (5) does not cover a business that leases employees.

Elective deferrals and employee contributions

In the case of amounts attributable to elective deferrals under a qualified cash or deferred arrangement and employee after-tax contributions that are invested in employer securities, any applicable individual would have to be permitted to direct that such amounts be invested in alternative investments.

Other contributions

In the case of amounts attributable to all other contributions (i.e., nonelective employer contributions and employer matching contributions), an applicable individual who is a participant with three years of service,[9] a beneficiary of such a participant, or a beneficiary of a deceased participant would have to be permitted to direct that such amounts be invested in alternative investments.

The proposal would provide a transition rule for amounts attributable to these other contributions that are invested in employer securities acquired before the first plan year for which diversification requirements apply. Under the transition rule, for the first three years for which the new diversification requirements apply to the plan, the applicable percentage of such amounts would be subject to diversification as shown in Table 1, below.

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

Plan year for which diversification applies:	Applicable percentage:
First year	33 percent (or, if greater, the amount that would be required under present-law ESOP diversification rule)
Second year	66 percent
Third year	100 percent

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

For example, suppose that the account of a participant with at least three years of service held 120 shares of employer stock contributed as matching contributions before the diversification requirements became effective. In the first year for which diversification applies, 33 percent (i.e., 40 shares) of that stock would be subject to the diversification requirements. In the second year for which diversification applies, an additional 33 percent (for a total of 66 percent), or an additional 40 shares of the stock (for a total of 80 shares), would be subject to the diversification requirements. In the third year for which diversification applies, 100 percent of the stock, or all 120 shares, would be subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee after-tax contributions would be fully subject to the diversification requirements, as would any new stock contributed to the account.

In determining the portion of the account subject to diversification under the transition rule, any previous diversification of employer securities pursuant to an election under the present-law ESOP diversification requirements would be taken into account. Suppose, in the example above, the plan is an ESOP and, besides 120 shares of employer stock, the account holds other assets attributable to the previous diversification of 30 shares of employer stock pursuant to an election under the present-law ESOP diversification requirements. In applying the transition rule, the previously diversified stock would be taken into account. As a result, the account would be treated as holding 150 shares of employer stock for purposes of the transition rule. In the first year for which diversification applies, 33 percent of 150 shares of stock (i.e., 50 shares) would be subject to the diversification requirements, reduced by the 30 shares of stock already diversified. As a result, 20 shares of stock held in the account would be subject to diversification for that first year. In the second year, an additional 33 percent (for a total of 66 percent) of 150 shares, or an additional 50 shares of stock (for a total of 100 shares), would be subject to the diversification requirements. In the third year, 100 percent of the stock, or all 150 shares, would be subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee after-tax contributions would be fully subject to the diversification requirements, as would any new stock contributed to the account.

Requirements for investment alternatives

In order to satisfy the diversification requirements, the plan would be required to give applicable individuals a choice of at least three investment options, other than employer securities, each of which would have to be diversified and have materially different risk and return characteristics. Other investment options offered by the plan generally would also have to be available. A plan could not impose restrictions or conditions with respect to the investment of employer securities that are not imposed on the investment of other plan assets (other than restrictions or conditions imposed by reason of the application of securities laws). A plan would not fail to meet the diversification requirements merely because the plan limited the times when investment changes could be made to periodic, reasonable opportunities that occur at least quarterly.

Effective Date

The proposal would generally be effective for plan years beginning after December 31, 2002. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal would be effective for plan years beginning after the earlier of (1) the later of December 31, 2003, or the date on which the last of such collective bargaining agreements terminated (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2004.

II. PROTECTION OF EMPLOYEES DURING PENSION PLAN TRANSACTION SUSPENSION PERIOD

A. Notice to Participants or Beneficiaries of Transaction Suspension Periods

Present Law

The Code and ERISA require various notices to be provided to participants and beneficiaries under an employer-sponsored retirement plan regarding their rights under the plan. Present law does not specifically require that participants be given advance notice of temporary periods during which the ability to direct investments or to obtain loans or distributions from the plan is restricted.

Failure to provide a notice required under the Code may result in the imposition of an excise tax (e.g., sec. 4980F, relating to notice requirements for plans significantly reducing benefit accruals) or a reporting penalty (e.g., sec. 6652(i), relating to a failure to give written explanation of qualifying rollover distributions). Failure to provide a notice required under ERISA may result in the imposition of a civil penalty.[10]

Description of Proposal

In general

Under the proposal, the Code and ERISA would require that advance notice of a transaction suspension period would have to be provided by the administrator of an applicable pension plan to the applicable individuals to whom the transaction suspension period applies (and to any employee organization representing such individuals). An applicable individual (as defined under the proposal relating to diversification) would be (1) any plan participant and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant. Generally, notice would have to be provided at least 30 days before the beginning of the transaction suspension period.

An applicable pension plan would be a qualified retirement plan or annuity, a tax-sheltered annuity plan, or an eligible deferred compensation plan of a governmental employer that maintains accounts for participants and beneficiaries.[11] An applicable pension plan would not include a one-person plan (as defined under the proposal relating to diversification).

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[10] ERISA also permits the Secretary of Labor, a participant, a beneficiary, or a plan fiduciary to bring civil action to enforce any ERISA requirements.

[11] The ERISA notice requirement would not apply to a plan that is exempt from ERISA, such as a governmental plan or a church plan.

Definition of transaction suspension period

A transaction suspension period would mean a period during which certain rights are significantly restricted if the rights are not restored within three consecutive business days from the day the rights are restricted. The rights that would be relevant for this purpose are rights otherwise provided under the plan to one or more applicable individuals to direct investments (including investments in employer securities) or to obtain loans or distributions from the plan. However, rights that are significantly restricted because of the application of securities laws or other circumstances specified in regulations and restrictions required in connection with a qualified domestic relations order would not be taken into account in determining whether a transaction suspension period occurs.

Whether an individual's right to direct investments or obtain loans or distributions from the plan is significantly restricted would generally be determined by reference to the normal rights and procedures provided under the plan. A variety of factors could be relevant in making this determination. For example, if, in connection with a change in plan recordkeepers, no investment directions, loans, or distributions can be executed over a three-day weekend (i.e., a Saturday, a Sunday, and a Monday that is a Federal holiday), then no transaction suspension period would result if the participants would not, under the terms of the plan, have been able to engage in such transactions during that period in any event. As another example, suppose a plan provided that a participant's loan request will be processed within 30 days from the time the loan request is submitted. The mere fact that, in connection with a change in plan administrators, the processing of loan requests is suspended for a ten-day period would not result in a transaction suspension period if participants' ability to submit loan requests continued during the ten-day period and the ten-day suspension did not cause the processing of loan requests to take longer than the 30-day period provided in the plan. In addition, if a plan provided that a participant's ability to make investment changes, or obtain a loan or a distribution, is limited for a certain period in connection with a qualified domestic relations order with respect to the participant's account, that limitation generally would not result in a transaction suspension period.

Factors in addition to the time period involved could also be relevant in determining whether a transaction suspension period occurs, and the relevant factors could vary depending on the rights affected. For example, suppose a plan offered a variety of investment options, including three options that have similar characteristics (e.g., similar risk and return characteristics). If the ability to transfer funds into only one of these options is restricted, this might not result in a transaction suspension period for purposes of the proposal, because participants would have the right to transfer funds into similar investment options. In addition, a transaction suspension period would not occur as a result of plan provisions that restrict a participant's right to direct the investment of the assets in his or her account to certain periods, such as the first fifteen days of each month.

Timing of notice

Notice of a transaction suspension period would generally be required at least 30 days before the beginning of the period. An exception would apply in the case of a transaction suspension period imposed because of an event outside the control of the plan sponsor or administrator. In that case, notice would be required to be provided as soon as reasonably

practicable under the circumstances. The Secretary of the Treasury would be given the authority to provide additional exceptions (and to specify the time when notice would be required) in the case of a transaction suspension period due to other circumstances specified by the Secretary, including the application of securities laws.

In the case of a transaction suspension period in connection with a major corporate disposition by a corporation maintaining the plan, the notice requirements would be treated as met if, not later than 30 days before the disposition, the plan administrator (or the corporation maintaining the plan) provides notice of the transaction suspension period, and no further notice would be required if the transaction suspension period begins within 30 days after the disposition. A "major corporate disposition" would mean the disposition of substantially all of the stock of the corporation, or a subsidiary thereof, or the disposition of substantially all of the assets used in a trade or business of the corporation or subsidiary. Similar rules would apply in the case of an entity that is not a corporation.

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

Form and content of notice

Notice of a transaction suspension period would have to be written in a manner calculated to be understood by the average plan participant and provide sufficient information (as determined under Treasury guidance) to allow the recipients to understand the timing and effect of the transaction suspension period. Specifically, the notice would be required to include (1) the reasons for the suspension, (2) an identification of the investments and other rights under the plan that are affected, (3) the expected period of the suspension,[12] and (4) in the case of a transaction suspension period involving the right to direct investments, a statement that the applicable individual should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the expected period of suspension. The notice would be required to be provided in writing and could be provided in electronic or other form that is reasonably expected to result in receipt of the notice by the applicable individual. The Secretary of the Treasury would be required, in consultation with the Secretary of Labor, to issue a model transaction suspension period notice.

Sanctions for failure to provide notice

Excise tax

An excise tax would generally apply in the case of a failure to provide notice of a transaction suspension period as required under the Code. A reporting penalty would apply in the case of a failure related to a governmental plan or a church plan.

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[12] If the expected length of the transaction suspension period changed after notice has been provided, notice of the change would have to be provided as soon as reasonably practicable.

Under the proposal, an excise tax would generally be imposed on the employer if notice of a transaction suspension is not provided.[13] The excise tax would be $100 per day for each applicable individual with respect to whom the failure occurred, until notice is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the notice requirements, the total excise tax imposed during a taxable year would not exceed $500,000.

No tax would be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the notice requirement. In addition, no tax would be imposed if the employer exercises reasonable diligence to comply and provides the required notice as soon as reasonably practicable after learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

The excise tax would not apply in the case of a failure to provide notice of a transaction suspension period with respect to a governmental plan or a church plan. In that case, on notice and demand by the Secretary, a penalty would apply of $100 per day for each applicable individual with respect to whom the failure occurs, until notice is provided or the failure is otherwise corrected.[14] The limitations and exceptions to the excise tax would apply also to the penalty.

ERISA civil penalty

In the case of a failure to provide notice of a transaction suspension period as required under ERISA, the Secretary of Labor would be authorized to assess a civil penalty of up to $100 per day for each violation.[15] For this purpose, each violation with respect to a single participant or beneficiary would be treated as a separate violation.

Effective Date

The proposal would generally be effective for plan years beginning after December 31, 2002. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal would be effective for plan years beginning after the earlier of (1) the later of December 31, 2003, or the date on which the last of such collective bargaining agreements terminated (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2004. No later than 120 days after enactment of the proposal, the Secretary of

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[13] In the case of a multiemployer plan, the excise tax would be imposed on the plan. In the case of a tax-sheltered annuity program under section 403(b) that is not treated as established or maintained by the employer for purposes of ERISA, the excise tax would be imposed on the plan administrator.

[14] In the case of a governmental plan, a penalty would not apply to a failure to provide notice to an employee organization.

[15] The civil penalty under ERISA would not apply to a governmental plan or a church plan because such plans are not subject to the requirements under ERISA.

the Treasury would be required to specify (1) the circumstances under which 30 days notice of a transaction suspension period is not required and (2) the time by which notice is required to be provided in those circumstances.

B. Inapplicability of Relief from Fiduciary Liability During Suspension of Ability of Participant or Beneficiary to Direct Investments

Present Law

Fiduciary rules under ERISA

ERISA contains general fiduciary duty standards that apply to all fiduciary actions, including investment decisions. ERISA requires that a plan fiduciary generally must discharge its duties solely in the interests of participants and beneficiaries and with care, prudence, and diligence. With respect to plan assets, ERISA requires a fiduciary to diversify the investments of the plan so as to minimize the risk of large losses, unless under the circumstances it is clearly prudent not to do so.[16]

A plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. A plan fiduciary may be liable also for a breach of responsibility by another fiduciary (a "co-fiduciary") in certain circumstances.

Special rule for participant control of assets

ERISA provides a special rule for a defined contribution plan that permits participants to exercise control over the assets in their individual accounts. Under the special rule, if a participant exercises control over the assets in his or her account (as determined under regulations), the participant is not deemed to be a fiduciary by reason of such exercise and no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's exercise of control.

In order for a participant to be treated as exercising control over the assets in his or her account:

- the plan must provide at least three different investment options, each of which is diversified and has materially different risk and return characteristics;
- the plan must allow participants to give investment instructions with respect to each investment option under the plan with a frequency that is appropriate in light of the reasonably expected market volatility of the investment option (the general volatility rule);
- at a minimum, participants must be allowed to give investment instructions at least every three months with respect to least three of the investment options, and those investment options must constitute a broad range of options (the three-month minimum rule);

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[16] Certain defined contribution plans are not subject to the diversification requirement for investments or the general prudence requirement (to the extent that it requires diversification) with respect to investments in employer stock.

- participants must be provided with detailed information about the investment options, information regarding fees, investment instructions and limitations, and copies of financial data and prospectuses; and
- specific requirements must be satisfied with respect to investments in employer stock to ensure that employees' buying, selling, and voting decisions are confidential and free from employer influence.

If these requirements are met, a plan fiduciary may be liable for the investment options made available under the plan, but not for the specific investment decisions made by participants.

Description of Proposal

Under the proposal, relief from fiduciary liability for any loss or breach resulting from a participant's exercise of control over assets generally would not apply in the case of a transaction suspension period during which the ability of the participant to direct the investment of the assets in his or her account is suspended by a plan sponsor or fiduciary. For this purpose, transaction suspension period would be defined as under the proposal requiring advance notice of a transaction suspension period. Under a special rule, if a transaction suspension period occurs in connection with a change in the investment options offered under the plan, a participant would be deemed to have exercised control over the assets in his or her account before the transaction suspension period if, after notice of the change in investment options is given to such participant, assets in the account of the participant are transferred either (1) to investment options in accordance with the participant's affirmative election, or (2) in the absence of an affirmative election by the participant, to investment options with reasonably comparable risk and return characteristics in the manner set forth in the notice.

In addition, if the fiduciary meets the requirements of ERISA in connection with authorizing the transaction suspension period, the fiduciary would not be liable for any loss occurring during the period as a result of a participant's or beneficiary's exercise of control over assets in his or her account before the period. Matters that would be considered in determining whether the requirements of ERISA were satisfied would include whether the fiduciary (1) considered the reasonableness of the expected transaction suspension period, (2) provided notice of the transaction suspension period (as required under another provision of the proposal), and (3) acted in accordance with the general fiduciary duty standards of ERISA in determining whether to enter into the transaction suspension period. The Secretary of Labor would be required, in consultation with the Secretary of Treasury, to issue, before December 31, 2002, final regulations providing guidance, including safe harbors, on how plan fiduciaries would be able to satisfy their fiduciary responsibilities during a transaction suspension period during which the ability of a participant or beneficiary to direct the investment of the assets in his or her account is suspended.

Effective Date

The proposal would generally be effective for plan years beginning after December 31, 2002. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal would be effective for plan years beginning after the earlier of (1) the later of December 31, 2003, or the date on which the last of such collective bargaining agreements

terminated (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2004.

C. Clarification of Participant Access to Remedies under ERISA

Present Law

Section 502(a) of ERISA contains several provisions under which a participant may bring civil action against a plan fiduciary.[17]

A participant may bring a civil action for appropriate relief under section 409 of ERISA (ERISA sec. 502(a)(2)). Under section 409 of ERISA, a plan fiduciary that breaches any of the fiduciary responsibilities, obligations, or duties imposed by ERISA is personally liable to make good to the plan any losses to the plan resulting from such breach and to restore to the plan any profits the fiduciary has made through the use of plan assets. In addition, the fiduciary is subject to other equitable or remedial relief as a court deems appropriate, including the removal of the fiduciary. Section 409 provides for broad relief in the case of a breach of fiduciary duty, including compensatory damages. However, a fiduciary may not be held personally liable to a participant for damages under section 409, even in the case of a civil action brought by the participant, because recovery under section 409 must be on behalf of the plan.[18] It is not clear under present law to what extent damages recovered under section 409 with respect to a breach of fiduciary liability affecting a participant's individual account under a defined contribution plan are to be allocated to the participant's account.

ERISA also gives a participant the right to bring a civil action--

- to recover benefits due to him or her under the terms of the plan, to enforce his or her rights under the terms of the plan, or to clarify his or her rights to future benefits under the terms of the plan ERISA (sec. 502(a)(1)(B)), or
- to enjoin any act or practice which violates any provision of this title or the terms of the plan, or to obtain other appropriate equitable relief to redress such violations or to enforce any provisions of this title or the terms of the plan (ERISA sec. 502(a)(3)).

These provisions enable a participant to seek recovery on his or her own behalf, not just on behalf of the plan, including recovery for a breach of fiduciary duty.[19] However, "appropriate equitable relief" that a participant may obtain on his or her own behalf does not include money damages (i.e., compensatory damages).[20] Participants in defined contribution plans who have brought action against a plan fiduciary under one of these ERISA provisions have been denied the recovery of damages for the difference between the earnings on their accounts and the amount of earnings they would have received if the plan administrator had complied with the

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[17] Some of these provisions also allow the Secretary of Labor or another plan fiduciary to bring a civil action.

[18] *Massachusetts Mutual Life Insurance Co. v. Russell*, 473 U.S. 134 (1985).

[19] *Varity Corporation v. Charles Howe*, 516 U.S. 489 (1996).

[20] *Mertens v. Hewitt Associates*, 508 U.S. 248 (1993).

participants' instructions as to the transfer or distribution of the accounts because lost earnings are considered compensatory damages.[21]

Description of Proposal

The proposal would amend section 409 of ERISA to clarify that, in the case of a fiduciary breach with respect to a defined contribution plan, the relief available under section 409 would, to the extent the court deemed appropriate, be apportioned to each individual account affected by the breach.

Effective Date

The proposal would be effective on the date of enactment of the proposal.

[21] *Helfrich v. PNC Bank, Kentucky, Inc.*, 267 F.3d 477 (6th Cir. 2001), *cert.den.*, reported at 2002 U.S. LEXIS 1558 (March 18, 2002); *Kerr v. Charles F. Vatterott & Co.*, 184 F.3d 938 (8th Cir. 1999).

D. Increased Maximum Bond Amount for Plans Holding Employer Securities

Present Law

ERISA generally requires every fiduciary and every person who handles funds or other property of a plan (a "plan official") to be bonded. The amount of the bond is fixed annually at no less than ten percent of the funds handled but must be at least $1,000 and not more than $500,000 (unless the Secretary of Labor prescribes a larger amount after notice and an opportunity to be heard). The bonds are intended to protect plans against loss from acts of fraud or dishonesty by plan officials. Qualifying bonds must have a corporate surety which is an acceptable surety on Federal bonds.

Description of Proposal

The proposal would raise the maximum bond amount to $1 million for fiduciaries of plans that hold employer securities.

Effective Date

The proposal would be effective for plan years beginning after December 31, 2002.

III. PROVIDING INFORMATION TO ASSIST PARTICIPANTS

A. Benefit Statements and Investment Guidelines

Present Law

Pension benefit statements

ERISA provides that a plan administrator must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. This requirement applies in the case of any plan that is subject to ERISA, including defined contribution and defined benefit plans. The benefit statement must indicate, on the basis of the latest available information, (1) the participant's or beneficiary's total accrued benefit, and (2) the participant's or beneficiary's vested accrued benefit or the earliest date on which the accrued benefit will become vested. A participant or beneficiary is not entitled to receive more than one benefit statement during any 12-month period. If the plan administrator fails or refuses to furnish the benefit statement within 30 days of the participant's or beneficiary's written request, the participant or beneficiary may bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or other relief that the court deems proper.[22]

Individual statements to participants on separation from service

A plan administrator must furnish an individual statement to each participant who (1) separates from service during the year, (2) is entitled to a deferred vested benefit under the plan as of the end of the plan year, and (3) whose benefits were not paid during the year.[23] The individual statement must set forth the nature, amount and form of the deferred vested benefit to which the participant is entitled. The plan administrator generally must provide the individual statement no later than 180 days after the end of the plan year in which the separation from service occurs. If the plan administrator fails to provide the individual statement, the Secretary of Labor or the participant may bring a civil action for appropriate relief.

Investment guidelines

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

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[22] ERISA also permits the Secretary of Labor, a participant, a beneficiary, or a fiduciary to bring civil action to enforce any ERISA requirements.

[23] This information is based on an annual registration statement that the plan administrator is required to file under the Code with the Secretary of Treasury with respect to all participants who meet these requirements for the plan year. The annual registration statement is filed by means of Schedule SSA of the Form 5500. The Code also requires that the plan administrator furnish an individual statement to the participant.

Description of Proposal

Pension benefit statements

In general

The proposal would provide new benefit statement requirements under the Code and ERISA, depending in part on the type of plan and the individual to whom the statement is provided.

Requirements for defined contribution plans

In the case of an applicable pension plan, the plan administrator would be required under the Code and ERISA to provide a benefit statement (1) to an applicable individual who has the right to direct the investment of the assets in his or her account, at least quarterly, (2) to other applicable individuals, at least annually, and (3) to a beneficiary who is not an applicable individual, upon written request, but limited to one request during any 12-month period. An applicable pension plan would be defined (as under the proposal relating to notice of a transaction suspension period) as a qualified retirement plan or annuity, a tax-sheltered annuity plan, or an eligible deferred compensation plan of a governmental employer that maintains accounts for participants and beneficiaries (other than a one-person plan).[24] An applicable individual would be defined (as under the proposal relating to notice of a transaction suspension period) as (1) any plan participant and (2) any beneficiary who has an account under the plan with respect to which the beneficiary is entitled to exercise the rights of a participant.

The benefit statement would be required to indicate, on the basis of the latest available information, (1) the total benefits accrued, and (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested. In addition, the statement would have to include the value of investments allocated to the individual's account (determined as of the plan's most recent valuation date), including the value of any employer securities (without regard to whether the securities were contributed by the employer or acquired at the direction of the individual), and an explanation of any limitations or restrictions on the right of the individual to direct investments.

Requirements for defined benefit plans

Under the proposal, the administrator of a defined benefit plan would generally be required under ERISA either (1) to furnish a benefit statement at least once every three years[25] to each participant who has a vested accrued benefit and who is employed by the employer at the

[24] The ERISA requirement would not apply to a plan that is exempt from ERISA, such as a governmental plan (including an eligible deferred compensation plan of a governmental employer) or a church plan.

[25] The Secretary of Labor would be authorized to provide that years in which no employer or former employee benefits under the plan need not be taken into account in determining the three-year period.

time the benefit statements are furnished to participants, or (2) to furnish at least annually to each such participant notice of the availability of a benefit statement and the manner in which the participant could obtain it. The notice could be included with other communications to the participant if done in a manner reasonably designed to attract the attention of the participant.

The administrator of a defined benefit plan would also be required to furnish a benefit statement to a participant or beneficiary upon written request, limited to one request during any 12-month period.

A benefit statement would be required to indicate, on the basis of the latest available information, (1) the total benefits accrued, and (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested. In the case of a statement provided to a participant (other than at the participant's request), information could be based on reasonable estimates determined under regulations prescribed by the Secretary of Labor.

Form of benefit statement

The benefit statement would be required to be written in a manner calculated to be understood by the average plan participant. It would be required to be provided in writing and could be provided in electronic or other form that is reasonably expected to result in receipt of the notice by the applicable individual.

The Secretary of Labor would be directed to develop one or more model benefit statements, written in a manner calculated to be understood by the average plan participant, that may be used by plan administrators in complying with the requirements of ERISA and the Code. The use of the model statement would be optional. It would be intended that the model statement include items such as the amount of nonforfeitable accrued benefits as of the statement date that are payable at normal retirement age under the plan, the amount of accrued benefits that are forfeitable but that may become nonforfeitable under the terms of the plan, information on how to contact the Social Security Administration to obtain a participant's personal earnings and benefit estimate statement, and other information that may be important to understanding benefits earned under the plan.

Investment guidelines

In general

Under the proposal, the plan administrator of an applicable pension plan would be required under the Code and ERISA to provide at least annually a model form relating to basic investment guidelines to applicable individuals.[26] "Applicable pension plan" and "applicable individual" would be defined as under the proposal relating to required benefit statements.

[26] The ERISA requirement would not apply to a plan that is exempt from ERISA, such as a governmental plan or a church plan.

Model form

Under the proposal, the Secretary of the Treasury would be directed, in consultation with the Secretary of Labor, to develop and make available a model form containing basic guidelines for investing for retirement. Such guidelines would generally include (1) information on the benefits of diversification of investments, (2) information on the essential differences, in terms of risk and return, of pension plan investments, including stocks, bonds, mutual funds and money market investments, (3) information on how an individual's investment allocations under the plan may differ depending on the individual's age and years to retirement, as well as other factors determined by the Secretary, (4) sources of information where individuals may learn more about pension rights, individual investing, and investment advice, and (5) such other information related to individual investing as the Secretary determines appropriate. In addition, the Secretary would have the authority to vary the required information depending on the type of plan. For example, some information could be omitted in the case of a plan does not provide for investment direction by participants.

The model form would be required also to include addresses for Internet sites, and a worksheet, that an individual could use to calculate (1) the retirement age annuity value of the individual's vested benefits under the plan (determined by reference to varied historical annual rates of return and annuity interest rates), and (2) other important amounts relating to retirement savings, including the amount that an individual would be required to save in order to provide a retirement income equal to various percentages of his or her current salary (adjusted for historical growth prior to retirement). The Secretary of Labor would also be required to develop an Internet site to be used by an individual in making these calculations, the address of which would be included in the model form.

The Secretary of the Treasury would be directed to provide at least 90 days for public comment before publishing final notice of the model form and to update the model form at least annually.

The model form would be required (1) to be written in a manner calculated to be understood by the average plan participant and (2) to be provided in writing or any other form (including electronic form) to the extent such other form is reasonably accessible to applicable individuals.

Sanctions for failure to provide information

Excise tax

Under the proposal, an excise tax would generally apply in the case of a failure to provide a benefit statement or an investment guideline model form as required under the Code. However, a reporting penalty would apply in the case of a failure related to a governmental plan or a church plan.

The excise tax would generally be imposed on the employer if a required benefit statement or model form is not provided.[27] The excise tax would be $100 per day for each participant or beneficiary with respect to whom the failure occurs, until the benefit statement or model form is provided or the failure is otherwise corrected. If the employer exercises reasonable diligence to meet the benefit statement or model form requirement, the total excise tax imposed during a taxable year would not exceed $500,000. The $500,000 annual limit would apply separately to failures to provide required benefit statements and failures to provide the model form.

No tax would be imposed with respect to a failure if the employer does not know that the failure existed and exercises reasonable diligence to comply with the benefit statement or model form requirement. In addition, no tax would be imposed if the employer exercises reasonable diligence to comply and provides the required benefit statement or model form within 30 days of learning of the failure. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

The excise tax would not apply in the case of a failure to provide a benefit statement or model form with respect to a governmental plan or a church plan. In that case, on notice and demand by the Secretary, a penalty would apply of $100 per day for each applicable individual with respect to whom the failure occurs, until the benefit statement or model form is provided or the failure is otherwise corrected. The limitations and exceptions to the excise tax would apply also to the penalty.

ERISA civil penalty

The ERISA remedies that apply in the case of a failure or refusal to provide a benefit statement under present law would apply if the plan administrator fails or refuses to furnish a benefit statement or model form required under the proposals.[28] That is, the participant or beneficiary would be entitled to bring a civil action to recover from the plan administrator $100 a day, within the court's discretion, or such other relief that the court deems proper.

Effective Date

The proposal would generally be effective for plan years beginning after December 31, 2003. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the proposal would be effective for plan years beginning after the earlier of (1) the later of December 31, 2004, or the date on which the last of such collective bargaining agreements

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[27] In the case of a multiemployer plan, the excise tax would be imposed on the plan. In the case of a tax-sheltered annuity program under section 403(b) that is not treated as established or maintained by the employer for purposes of ERISA, the excise tax would be imposed on the plan administrator.

[28] The civil penalty under ERISA would not apply to a governmental plan or a church plan because such plans are not subject to the requirements under ERISA.

terminated (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2005.

B. Information on Optional Forms of Benefit

Present Law

Under a defined benefit plan or a money purchase pension plan, benefits 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. In the case of a married participant, benefits must be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to another form of benefit. A QJSA is an annuity for the life of the participant, with a survivor annuity for the life of the spouse which is not less than 50 percent (and not more than 100 percent) of the amount of the annuity payable during the joint lives of the participant and his or her spouse. The participant and his or her spouse may waive the right to a QJSA provided certain requirements are satisfied, including a requirement that a written explanation be provided of the effect of a waiver of the annuity.

Defined benefit 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 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.

In addition, statutory actuarial assumptions must be used in determining the minimum value of certain optional forms of benefit, such as a lump sum. 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 Internal Revenue Service) and an applicable interest rate.

Description of Proposal

Under the proposal, the Secretary of the Treasury would be directed to issue (within 30 days of enactment of the proposal) regulations requiring the plan administrator of a defined benefit plan or a money purchase pension plan to provide a statement comparing the relative values of each form of benefit payable under the plan. The statement would be required to be written in a manner calculated to be understood by the average plan participant and to include such information as the Secretary determines appropriate to enable the average plan participant, spouse, or surviving spouse to make an informed decision as to what form of benefit to elect. For example, in the case of a plan that provides a subsidized early retirement annuity benefit, it would be intended that the information would include an explanation of whether the subsidy is included in determining other forms of benefit (e.g., a lump sum) payable at early retirement age.

Effective Date

The proposal would be effective on the date of enactment.

C. Fiduciary Duty to Provide Material Information Relating to Investment in Employer Stock

Present Law

ERISA imposes broad duties governing all plan fiduciaries. Among them are the requirements that plan fiduciaries discharge their duties with respect to plans solely in the interest of plan participants and beneficiaries for the exclusive purpose of providing benefits and that such fiduciaries act with reasonable care, skill, prudence, and diligence under the circumstances. Under ERISA, fiduciaries must also refrain from engaging in prohibited transactions. Despite these general fiduciary requirements, in the case of defined contribution plans that permit participants and beneficiaries to exercise control over the investment of assets in their accounts, plan fiduciaries are generally not liable for any losses resulting from the exercise of such control.

Description of Proposal

The proposal would amend ERISA to provide that the sponsor and administrator of a defined contribution plan have a duty to ensure that, in connection with the investment of assets in a participant's account in employer stock, a participant is provided with all material information that would generally be required to be disclosed by the employer to investors under applicable securities laws. The provision of misleading information by the employer or plan administrator would be a violation of this requirement. In the case of a failure to provide the information as required under the proposal, the Secretary of Labor would be authorized to assess a civil penalty of up to $1,000 per day.

Effective Date

The proposal would be effective with respect to plan years beginning after December 31, 2002.

D. Electronic Disclosure of Insider Trading

Present Law

ERISA contains broad rules governing the provision of information to participants and beneficiaries by plans and plan administrators. These reporting and disclosure rules are designed to ensure that participants and beneficiaries are advised of their rights and benefits under plans and applicable law, are given access to plan financial information, and are given adequate opportunity to prevent or redress any violations of their rights.

Description of Proposal

The proposal would amend ERISA to require that, an employer that sponsors an individual account plan that permits elective deferrals to be invested in employer stock or real property would be required to disclose to participants and beneficiaries any stock transaction by an officer, director, or affiliate of the employer that must be disclosed to the SEC. The disclosure would be required to be posted on the plan's website in a reasonably practicable timeframe after disclosure to the SEC (or provided upon request, in the case of a participant or beneficiary who does not have access to a plan website). The SEC would be permitted to accept this electronic disclosure in place of any form of disclosure otherwise required with respect to participants and beneficiaries.

Effective Date

The proposal would be effective with respect to plan years beginning after December 31, 2002.

IV. INDEPENDENT INVESTMENT ADVICE

A. Fiduciary Rules for Plan Sponsors Designating Independent Investment Advisors

Present Law

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

Description of Proposal

In general

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

Qualified investment adviser

Under the proposal, a "qualified investment adviser" would be defined as a person who is a plan fiduciary by reason of providing investment advice and who is also (1) a registered investment adviser under the Investment Advisers Act of 1940 or registered as an investment adviser under the laws of the State (consistent with section 203A of the Investment Advisers Act[29]) in which the adviser maintains its principal office, (2) a bank or similar financial institution, (3) an insurance company qualified to do business under State law, or (4) a comparably qualified entity under criteria to be established by the Secretary of Labor. In addition, any individual who provided investment advice to participants on behalf of the investment adviser (such as an employee thereof) would be required to be (1) a registered

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

investment adviser under Federal or State law as described above,[30] (2) a registered broker or dealer under the Securities Exchange Act, (3) a registered representative under the Securities Exchange Act or the Investment Advisers Act, or (4) any comparably qualified individual under criteria to be established by the Secretary of Labor.

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

Requirements for employer or other fiduciary

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

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

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

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

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

Effective Date

The proposal would apply to advisers designated after the date of enactment of the proposal.

V. OTHER PROPOSALS RELATING TO PENSION PLANS

A. Studies

Present Law

Present law does not require studies specifically relating to the revitalization of defined benefit plans, floor-offset ESOPs, an insurance system for defined contribution plans, or fees related to the investment of defined contribution plan assets.

Description of Proposal

Study on revitalizing defined benefit plans

The Secretary of the Treasury would be required to undertake a study on ways to revitalize employer interest in defined benefit plans and to report the results thereof, with recommendations for legislative changes, within 18 months after the date of enactment of the proposal, to the House Committees on Ways and Means and the Senate Committee on Finance. In conducting the study, the Secretary would be required to consider (1) ways to encourage the establishment of defined benefit plans by small and mid-sized employers, (2) ways to encourage the continued maintenance of defined benefit plans by larger employers, and (3) legislative proposals to accomplish these objectives.

Study on floor-offset ESOPs[31]

The Pension Benefit Guaranty Corporation (the "PBGC") would be required to undertake a study to determine the number of floor-offset ESOPs still in existence and the extent to which such plans pose a risk to plan participants or beneficiaries or to the PBGC and to report the results thereof, with legislative proposals, within 12 months after the date of enactment of the proposal, to the House Committee on Ways and Means, the House Committee on Education and the Workforce, the Senate Committee on Finance, and the Senate Committee on Health, Education, Labor and Pensions.

Study regarding insurance system for individual account plans

The PBGC would be required, as soon as practicable after the date of enactment of the proposal, to undertake a study relating to the establishment of an insurance system for defined contribution plans and to report the results thereof, with recommendations for legislative

[31] A floor-offset arrangement is an arrangement under which benefits payable to a participant under a defined benefit plan are reduced by benefits under a defined contribution plan. Generally, in the case of a floor-offset arrangement, ERISA prohibits the defined contribution plan from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer stock. However, under a special transition rule, this prohibition does not apply to a defined contribution plan, including an ESOP, that is part of a floor-offset arrangement established on or before December 17, 1987.

changes, within two years after the date of enactment of the proposal, to the House Committee on Education and the Workforce and the Senate Committee on Health, Education, Labor and Pensions. In conducting the study, the PBGC would be required to consider the feasibility of such a system, the problem with insuring investments in employer securities, and options for developing such a system.

Study regarding fees charged by individual account plans

The Department of Labor (the "DOL") would be required to undertake a study of the administrative and transaction fees incurred by participants and beneficiaries in connection with the investment of assets in their accounts under defined contribution plans and to report the results thereof, with recommendations for legislative changes, within one year after the date of enactment of the proposal, to the House Committee on Education and the Workforce and the Senate Committee on Health, Education, Labor and Pensions. In conducting the study, the DOL would be required to consider how the fees compare to fees charged for similar services provided to investors not in individual account plans and whether participants and beneficiaries are adequately notified of the fees.

Effective Date

The proposal would be effective on the date of enactment.

B. Plan Amendments

Present Law

Plan amendments to reflect amendments to the law generally must be made by the time prescribed by law for filing the income tax return of the employer for the employer's taxable year in which the change in law occurs.

Description of Proposal

The proposal would allow certain plan amendments made pursuant to the pension proposals described herein or the provisions of title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001 (or regulations issued thereunder) to be retroactively effective. If the plan amendment meets the requirements of the proposal, then the plan would be treated as being operated in accordance with its terms and the amendment would not violate the prohibition of reductions of accrued benefits. In order for this treatment to apply, the plan amendment would be required to be made on or before the last day of the first plan year beginning on or after January 1, 2005 (January 1, 2007, in the case of a governmental plan). If the amendment is required to be made to retain qualified status as a result of the changes in the law (or regulations), the amendment would be required to be made retroactively effective as of the date on which the change became effective with respect to the plan and the plan would be required to be operated in compliance until the amendment is made. Amendments that are not required to retain qualified status but that are made pursuant to the pension proposals described herein or the 2001 Act (or applicable regulations) could be made retroactive as of the first day the plan is operated in accordance with the amendment.

A plan amendment would not be considered to be pursuant to a pension proposal described herein or a provision of the 2001 Act (or applicable regulations) if it has an effective date before the effective date of the proposal or the provision of the Act (or regulations) to which it related. Similarly, relief from section 411(d)(6) would not apply for periods prior to the effective date of the relevant proposal or provision (or regulations) or the plan amendment.

The Secretary would be authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It would be intended that the Secretary would not permit inappropriate reductions in contributions or benefits that are not directly related to the pension proposals described herein or the provisions of the bill or the 2001 Act. For example, it would be intended that a plan that incorporates the section 415 limits by reference could be retroactively amended to impose the section 415 limits in effect before the 2001 Act.[32] On the other hand, suppose a plan incorporates the section 401(a)(17) limit on compensation by reference and provides for an employer contribution of three percent of compensation. It would

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[32] See also, section 411(j)(3) of the Job Creation and Worker Assistance Act of 2002, which provides a special rule for plan amendments adopted on or before June 30, 2002, in connection with the Economic Growth and Tax Relief Reconciliation Act of 2001 (the "2001 Act"), in the case of a plan that incorporated the section 415 limits by reference on June 7, 2001, the date of enactment of the 2001 Act.

be expected that the Secretary would provide that the plan cannot be amended retroactively to reduce the contribution percentage for those participants not affected by the section 401(a)(17) limit, even though the reduction would result in the same dollar level of contributions for some participants because of the increase in compensation taken into account under the plan as a result of the increase in the section 401(a)(17) limit under the 2001 Act. As another example, suppose that under present law a plan is top-heavy and therefore a minimum benefit is required under the plan, and that under the provisions of the 2001 Act, the plan is not considered to be top-heavy. It would be expected that the Secretary would generally permit plans to be retroactively amended to reflect the new top-heavy provisions of the 2001 Act.

Effective Date

The proposal would be effective on the date of enactment.

VI. PROVISIONS RELATING TO EXECUTIVE COMPENSATION

A. Repeal of Limitation on Issuance of Treasury Guidance Regarding Nonqualified Deferred Compensation

Present Law

General tax treatment of nonqualified deferred compensation

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). Income is not constructively received if the taxpayer's control of its receipt is subject to substantial limitations or restrictions.

If the arrangement is funded, then it is generally treated as a transfer of property under section 83, and income is includible for the year in which the individual's right to the property is transferable or is not subject to a substantial risk of forfeiture. Deferred amounts that are subject to the claims of general creditors are generally treated as unfunded and unsecured promises to pay money or property in the future, which are not includible in income under section 83 when deferred.

Special statutory provisions govern the timing of the deduction for nonqualified deferred compensation, regardless of whether the arrangement covers employees or nonemployees and regardless of whether the arrangement is funded or unfunded.[33] Under these provisions, the amount of nonqualified deferred compensation that is includible in the income of the individual performing services is deductible by the service recipient for the taxable year in which the amount is includible in the individual's income.

Rulings on nonqualified deferred compensation

In the 1960's and early 1970's, various IRS revenue rulings considered the tax treatment of nonqualified deferred compensation arrangements.[34] Under these rulings, a mere promise to

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[33] Secs. 404(a)(5), (b) and (d) and sec. 83(h).

[34] The seminal ruling dealing with nonqualified deferred compensation is Rev. Rul. 60-31, 1960-1 C.B. 174.

pay, not represented by notes or secured in any way, was not regarded as the receipt of income for tax purposes. However, if an amount was contributed to an escrow account or trust on the individual's behalf, to be paid to the individual in future years with interest, the amount was held to be includible in income under the economic benefit doctrine. Deferred amounts were not currently includible in income in situations in which nonqualified deferred compensation was payable from general corporate funds that were subject to the claims of general creditors and the plan was not funded by a trust, or any other form of asset segregation to which individuals had any prior or privileged claim.[35] Similarly, current income inclusion did not result when the employer purchased an annuity contract to provide a source of funds for its deferred compensation liability if the employer was the applicant, owner and beneficiary of the annuity contract, and the annuity contract was subject to the general creditors of the employer.[36] In these situations, deferred compensation amounts were held to be includible in income when actually received or otherwise made available.

Proposed Treasury regulation 1.61-16, published in the Federal Register for February 3, 1978, provided that if a payment of an amount of a taxpayer's compensation is, at the taxpayer's option, deferred to a taxable year later than that in which such amount would have been payable but for his exercise of such option, the amount shall be treated as received by the taxpayer in such earlier taxable year.[37]

Section 132 of the Revenue Act of 1978

Section 132 of the Revenue Act of 1978[38] was enacted in response to proposed Treasury regulation 1.61-16. Section 132 of the Revenue Act of 1978 provides that the taxable year of inclusion in gross income of any amount covered by a private deferred compensation plan is determined in accordance with the principles set forth in regulations, rulings, and judicial decisions relating to deferred compensation which were in effect on February 1, 1978. The term, "private deferred compensation plan" means a plan, agreement, or arrangement under which the person for whom service is performed is not a State or a tax-exempt organization and under which the payment or otherwise making available of compensation is deferred. However, the provision does not apply to certain employer-provided retirement arrangements (e.g., a qualified retirement plan), a transfer of property under section 83, or an arrangement that includes a nonexempt employees trust under section 402(b). Section 132 was not intended to restrict judicial interpretation of the law relating to the proper tax treatment of deferred compensation or

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

[36] Rev. Rul. 72-25, 1972-1 C.B. 127. *See also*, Rev. Rul. 68-99, 1968-1 C.B. 193, in which the employer's purchase of an insurance contract on the life of the employee did not result in an economic benefit to the employee if all rights to any benefits under the contract were solely the property of the employer and the proceeds of the contract were payable only to the employer.

[37] Prop. Treas. Reg. 1.61-16, 43 Fed. Reg. 4638 (1978).

[38] Pub. L. No. 95-600.

interfere with judicial determinations of what principles of law apply in determining the timing of income inclusion.[39]

Description of Proposal

The proposal would repeal section 132 of the Revenue Act of 1978. It is intended that the Secretary of the Treasury would issue guidance with respect to the tax treatment of nonqualified deferred compensation arrangements focusing on arrangements that improperly defer income. For example, it is intended that the Secretary would address what is considered a substantial limitation under the constructive receipt doctrine and situations in which an individual's right to receive compensation is, at least in form, subject to substantial limitations, but in fact is not so limited. It is also intended that the Secretary would address situations which in form appear to not be funded, but in substance should be treated as so. In addition, it is intended that the Secretary would address situations in which assets are in form subject to the claims of an employer's general creditors, but are in substance unable to be reached by creditors. Arrangements that the Secretary would be expected to address include the following: the ability to receive funds on account of financial hardship, the use of trusts or other arrangements under which the rights of general creditors to gain access to funds is limited, the use of triggers and third-party guarantees to fund arrangements, and the ability to receive funds subject to a forfeiture of some portion of the participant's deferred compensation (sometimes referred to as a "haircut").

It is not intended that the Secretary take the position (as taken in proposed Treasury regulation 1.61-16) that all elective nonqualified deferred compensation is currently includible in income.

No inference would be intended that the Secretary is prohibited under present law from issuing guidance with respect to nonqualified deferred compensation arrangements or that any existing nonqualified deferred compensation guidance issued by the Secretary is invalid. In addition, no inference would be intended that any arrangements covered by future guidance provide permissible deferrals of income under present law.

Effective Date

The proposal would be effective for taxable years beginning after the date of enactment.

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[39] The legislative history to the provision states that the Congress believed that the doctrine of constructive receipt should not be applied to employees of taxable employers as it would have been under the proposed regulation. The Congress also believed that the uncertainty surrounding the status of deferred compensation plans of taxable organizations under the proposed regulation was not desired and should not be permitted to continue.

B. Taxation of Deferred Compensation Provided through Offshore Trusts

Present Law

The determination of when amounts deferred under a nonqualified deferred compensation arrangement are includible in the gross income of the individual earning the compensation depends on the facts and circumstances of the arrangement. A variety of tax principles and Code provisions may be relevant in making this determination, including the doctrine of constructive receipt, the economic benefit doctrine, the provisions of section 83 relating generally to transfers of property in connection with the performance of services, and provisions relating specifically to nonexempt employee trusts (sec. 402(b)) and nonqualified annuities (sec. 403(c)).

In general, the time for inclusion of nonqualified deferred compensation depends on whether the arrangement is unfunded or funded. If the arrangement is unfunded, then the compensation is generally includible in income when it is actually or constructively received (i.e., when it is paid or otherwise made available). If the arrangement is funded, then it is generally treated as a transfer of property under section 83, and income is includible for the year in which the individual's right to the property is transferable or is not subject to a substantial risk of forfeiture.

The application of section 83 to a funded nonqualified deferred compensation arrangement is based in part on the broad scope of section 83 (i.e., section 83 applies to any transfer of property in connection with the performance of services) and the broad definition of property under section 83.[40] Under section 83, the excess of the fair market value of property received in connection with the performance of services over the amount, if any, paid for the property is includible in the income of the person performing the services. Section 83 applies to a transfer of property to any service provider; its application is not limited to employees or even to individuals. A transfer of property occurs for purposes of section 83 when a person acquires a beneficial ownership interest in such property.

The term "property" is defined very broadly for purposes of section 83.[41] Property includes real and personal property other than money or an unfunded and unsecured promise to pay money in the future. Property also includes a beneficial interest in assets (including money) that are transferred or set aside from claims of the creditors of the transferor, for example, in a trust or escrow account. Accordingly, if, in connection with the performance of services, vested contributions are made to a trust on an individual's behalf and the trust assets may be used solely to provide future payments to the individual, the payment of the contributions to the trust constitutes a transfer of property to the individual that is taxable under section 83. Deferred

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[40] Depending on the design of a particular nonqualified deferred compensation arrangement (e.g., if it covers only employees), either the economic benefit doctrine or Code provisions dealing with nonexempt employee trusts and nonqualified annuities may be relevant as legal authority for this tax treatment in addition to section 83.

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

amounts are generally not includible in income in situations where nonqualified deferred compensation is payable from general corporate funds that are subject to the claims of general creditors, as such amounts are treated as unfunded and unsecured promises to pay money or property in the future.

Rabbi trusts

A "rabbi trust" is a trust or other fund established by the employer to hold assets from which nonqualified deferred compensation payments will be made. The trust or fund is generally irrevocable and does not permit the employer to use the assets for purposes other than to provide nonqualified deferred compensation. However, the terms of the trust or fund provide that the assets are subject to the claims of the employer's creditors in the case of bankruptcy.

As discussed above, for purposes of section 83, property includes a beneficial interest in assets set aside from the claims of creditors, such as in a trust or fund, but does not include an unfunded and unsecured promise to pay money in the future. In the case of a rabbi trust, terms providing that the assets are subject to the claims of creditors of the employer in the case of bankruptcy have been the basis for the conclusion that the creation of a rabbi trust does not cause the related nonqualified deferred compensation arrangement to be funded for income tax purposes.[42] As a result, no amount is included in income by reason of the rabbi trust; generally income inclusion occurs as payments are made from the trust.

The Internal Revenue Service has issued guidance setting forth model Rabbi Trust provisions.[43] Revenue Procedure 92-64 provides a safe harbor for taxpayers who adopt and maintain grantor trusts in connection with unfunded deferred compensation arrangements. The model trust language requires that the trust provide that the all assets of the trust are subject to the claims of the general creditors of the company.

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

Description of Proposal

The proposal would provide that assets that are designated or otherwise available for the use of providing nonqualified deferred compensation and are located outside the United States (e.g., in a foreign trust, arrangement or account) are not treated as subject to the claims of general creditors. Therefore, amounts deferred in such cases would not be treated as unfunded and unsecured promises to pay. Such nonqualified deferred compensation amounts would be treated

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[42] This conclusion was first provided in a 1980 private ruling issued by the IRS with respect to an arrangement covering a rabbi; hence the popular name "rabbi trust." Priv. Ltr. Rul. 8113107 (Dec. 31, 1980).

[43] Rev. Proc. 92-64, 1992-2 C.B. 422, modified in part by Notice 2000-56, 2000-2 C.B. 393.

as property under section 83 and the value of the compensation deferred would be includible in income when the right to the compensation is no longer subject to a substantial risk of forfeiture, regardless of when the compensation is paid. No inference would be intended with respect to the treatment of such arrangements under present law.

The proposal would not apply to deferred compensation arrangements covering employees located in a foreign jurisdiction if substantially all of the services with respect to which the property was transferred are performed in such foreign jurisdiction.

The proposal would provide the Secretary of the Treasury authority to provide additional exceptions for specific arrangements which do not result in improper deferral of U.S. tax. For example, it is intended that the Secretary would provide exceptions for arrangements in which deferred amounts are readily accessible under U.S. bankruptcy laws.

Effective Date

The proposal would be effective for amounts deferred after the date of enactment.

C. Treatment of Loans to Executives

Present Law

In general, gross income includes all income from any source, including compensation for past, present or future services, unless an exclusion applies. The proceeds of a bona fide loan are not income for Federal tax purposes, because the recipient is obligated to repay the loan. The issue of whether a payment is a bona fide loan or represents income to the payee may arise in various contexts (including in an employment context) and depends on the facts and circumstances. In analyzing whether there is an obligation to repay an amount, relevant factors include the existence of (1) a promissory note or other evidence of indebtedness, (2) a schedule for repayment of the amount with interest, (3) collateral or security, and (4) the payee's ability to repay.

Under present law, below-market-rate loans between certain parties are recharacterized as an arm's length transaction in which the lender made a loan to the borrower in exchange for a note requiring the payment of interest at the applicable Federal rate. In the case of compensation-related loans, this rule results in the parties being treated as if: (1) the borrower paid interest to the lender at the applicable Federal rate which is includible in income by the lender, and (2) the lender paid compensation to the employee or other person performing services. A compensation-related loan is a below-market loan directly or indirectly between an employer and an employee or an independent contractor and a person for whom such independent contractor provides services.

In general, a below-market-rate loan is a demand loan, the interest on which is payable at less than the applicable Federal rate, or a term loan, if the amount of the loan exceeds the present value of all payments due under the loan, using a discount rate equal to the applicable Federal rate. A demand loan is any loan which is payable on demand of the lender; a term loan is any loan other than a demand loan.

Description of Proposal

In general

The proposal would treat certain loans to applicable individuals as compensation, and would increase the imputed interest rate on below-market rate loans for loans to applicable individuals with an outstanding loan balance in excess of $1 million. An applicable individual would be an employee (or independent contractor) who is an officer, director, or five-percent owner of the employer (or service recipient). In addition, the proposal treating certain loans as compensation would apply to any loan made to an employee or independent contractor if outstanding loans from the employer (or service provider) exceed $1 million.

Certain loans treated as compensation

Under the proposal, a direct or indirect loan made to an applicable individual (including, for example, a loan in connection with split-dollar life insurance arrangements) would be treated as compensation (and therefore includible in gross income and wages for payroll tax purposes)

unless (1) there is a promissory note or other written evidence of indebtedness, (2) there is collateral or security for the debt, other than compensation-related property, and (3) there is a fixed schedule for payment of principal and interest,[44] not to exceed 10 years. Compensation-related property would mean any assets acquired by the applicable individual by reason of the performance of services by the individual for the employer (or service recipient), including any stock or capital or profits interest in the employer, any option or other contract to purchase such stock or interests, any restricted stock or ownership interest, or any nonqualified deferred compensation. For example, if an applicable individual uses stock acquired with a loan from the employer (or service recipient) as collateral for a loan, the stock would be considered compensation-related property, and the loan would be treated as compensation and wages under the proposal.

If the individual repays to the employer (or service recipient) an amount treated as compensation under the proposal, then the individual would be entitled to a deduction for the amount repaid as a miscellaneous itemized deduction (subject to the two-percent floor on such deductions) in the year of repayment to the extent the amount had been includible in gross income. The amount of wages taken into account for employment tax purpose for the year of the repayment would be reduced by the amount of the repayment previously included as wages. The employer (or other service recipient) would be required to include in income any payments of interest, and any repayment of loans treated as compensation for which a deduction was taken. Special rules would apply in determining the application of the below-market-rate loan rules to repayments of loans treated as compensation under the proposal.

Loans from qualified plans and relocation loans would not be subject to the proposal. A relocation loan would be a loan the proceeds of which are used by the employee to purchase a principal residence if the purchase is in connection with the commencement of work by an employee or a change in the principal work of an employee to which section 217 applies (relating to the deduction for moving expenses).

Treasury would be authorized to issue appropriate regulations to carry out the intent of the provision, including rules addressing situations such as the payment of a bonus that coincides with a payment under the loan agreement, and rules specifying the proper treatment of an arrangement treated as a loan when made if the employee subsequently fails to make scheduled payments when due.

Imputed interest rate for below-market-rate loans

If the amount of all outstanding loans of applicable individuals with respect to the same service recipient exceeds $1 million, then the interest rate imputed under the below-market-rate loan rules would be the applicable Federal rate plus three percentage points.

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[44] The below-market-rate loan rules (as modified by the proposal) would apply if sufficient interest is not required under the terms of the loan.

Effective Date

The proposal would be effective for loans made or refinanced after the date of enactment. Except as provided by the Secretary, modifications to a loan after the effective date would be considered a new loan.

D. Required Wage Withholding at Top Marginal Rate for Supplemental Wage Payments in Excess of $1 Million

Present Law

An employer must withhold income taxes from wages paid to employees; there are several possible methods for determining the amount of income tax to be withheld. The IRS publishes tables (Publication 15, "Circular E") to be used in determining the amount of income tax to be withheld. The tables generally reflect the income tax rates under the Code so that withholding approximates the ultimate tax liability with respect to the wage payments. In some cases, "supplemental" wage payments (e.g., bonuses or commissions) may be subject to withholding at a flat rate[45], based on the third lowest income tax rate under the Code (27 percent for 2002).[46]

Description of Proposal

Under the proposal, once annual supplemental wage payments to an employee exceed $1 million, any additional supplemental wage payments to the employee in that year would be subject to withholding at the highest income tax rate (38.6 percent for 2002), regardless of any other withholding rules and regardless of the employee's Form W-4.

This rule would apply only for purposes of wage withholding; other types of withholding (such as pension withholding and backup withholding) would not be affected.

Effective Date

The proposal would be effective with respect to wage payments made after December 31, 2002.

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[45] See section 13273 of the Revenue Reconciliation Act of 1993.

[46] See section 101(c)(11) of the Economic Growth and Tax Relief Reconciliation Act of 2001.