DESCRIPTION OF THE CHAIRMAN'S MODIFICATION TO THE PROPOSALS OF THE "HIGHWAY INVESTMENT, JOB CREATION AND ECONOMIC GROWTH ACT OF 2012"

Scheduled for Markup
by the
SENATE COMMITTEE ON FINANCE
on February 7, 2012

Prepared by the Staff
of the
JOINT COMMITTEE ON TAXATION

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INTRODUCTION

This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's modification to the proposals of the "Highway Investment, Job Creation and Economic Growth Act of 2012," which is scheduled to be marked up by the Senate Committee on Finance on February 7, 2012.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of the Chairman's Modification to the Proposals of the "Highway Investment Job Creation and Economic Growth Act of 2012"* (JCX-11-12), February 7, 2012. This document can also be found on our website at www.jct.gov. Unless otherwise stated, all section references are to the Internal Revenue Code of 1986, as amended.

A. Proposals Modifying the Proposals in the Chairman's Mark

1. Modification to item II.B of the Chairman's Mark regarding claims and credit carryovers relating to unprocessed and excluded fuels

The chairman's modification disallows the cellulosic biofuel producer credits and related carryovers arising from claims of credit relating to unprocessed and excluded fuels. However, taxpayers will be permitted to claim a 50 cents-per-gallon credit or payment for such fuels sold or used before January 1, 2010.

2. Modification to item II.F of the Chairman's Mark regarding the appropriation to the Highway Trust Fund of certain import tariffs

The chairman's modification extends the appropriations of tariff revenue through fiscal year 2016 so that additional revenue and savings funded by the Mark and Modification are transferred to the Highway Trust Fund.

B. Additional Proposals

1. Treatment of securities of a controlled corporation exchanged for assets in certain reorganizations

Present Law

The transfer of assets by a transferor corporation to another corporation, controlled (immediately after the transfer) by the transferor or one or more of its shareholders, will qualify as a tax-free reorganization if the transfer is made by one corporation ("distributing") of a part of its assets consisting of an active trade or business meeting certain requirements to a controlled subsidiary corporation ("controlled"), followed by the distribution of the stock and securities of the controlled subsidiary in a divisive spin-off, split-off, or split-up which was not used principally as a device for the distribution of earnings and profits ("divisive D reorganization").[2]

No gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock or securities in another corporation a party to the reorganization.[3] If property other than stock or securities is received ("other property"), gain is recognized to the extent the other property is not distributed.[4]

In addition, in the case of a transfer of money or other property received in the exchange to the corporation's creditors in connection with the reorganization, gain is recognized to the extent the sum of the money and the fair market value of the other property exceeds the adjusted bases of the assets transferred (net of liabilities).[5] Such a transfer to creditors is aggregated with other assumptions of the transferor corporation's liabilities by the transferee, which generally cause gain recognition if they exceed the adjusted basis of assets transferred.[6]

For example, if in a divisive D reorganization the controlled corporation either (1) directly assumes the debt of the distributing corporation, or (2) borrows and distributes cash to the distributing corporation to pay the distributing corporation's creditors, such debt assumption or cash distribution is treated as money received by the distributing corporation, and is taxable to the extent it exceeds the distributing corporation's basis in the assets transferred to the controlled corporation. By contrast, if the controlled corporation leverages itself by issuing its debt securities to the distributing corporation, the controlled corporation's debt securities are not treated as money received by the distributing corporation. Thus, the distributing corporation

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[2] Secs. 355 and 368(a)(1)(D). Section 355 imposes other requirements to avoid gain recognition at the corporate level with respect to the spin off, split up, or split off, e.g., secs. 355(d) and (e).

[3] Sec. 361(a).

[4] Sec. 361(b).

[5] The last sentence of sec. 361(b)(3).

[6] Sec. 357(c).

could use the controlled corporation's securities to retire the distributing corporation's own debt, recognize no gain, and be in the same economic position as if its debt had been directly assumed by the controlled corporation or as if it had retired its debt with cash received from the controlled corporation.

Description of Proposal

Under the proposal, in the case of a divisive D reorganization, no gain or loss is recognized to a corporation if the corporation is a party to a reorganization and exchanges property, in pursuance of the plan of reorganization, solely for stock other than nonqualified preferred stock (as defined in section 351(g)(2)).[7] Thus, under the proposal, securities and nonqualified preferred stock are treated as "other property."

Under the proposal, the transferor corporation's gain on the exchange is recognized to the extent of the sum of money and the value of other property, including securities and nonqualified preferred stock, not distributed in pursuance of the plan of reorganization. Also, gain on the exchange is recognized to the extent that the sum of money and the value of all property other than stock that is not nonqualified preferred stock which is transferred to creditors exceeds the adjusted bases of the assets transferred (net of liabilities).

For example, under the proposal, in a divisive D reorganization, the exchange of the controlled corporation's securities for the distributing corporation's securities would be treated in the same manner as (1) the assumption of the distributing corporation's debt by the controlled corporation or (2) the use of a cash distribution from the controlled corporation to retire debt of the distributing corporation.

Effective Date

The proposal applies to exchanges occurring after the date of enactment.

[7] Section 351(g)(2) defines nonqualified preferred stock as preferred stock if (i) the holder has a right to require the issuer or a related person to redeem or purchase the stock, which right may be exercised within the 20 year period beginning on the issue date and is not subject to a contingency which, as of the issue date, makes remote the likelihood of redemption or purchase; (ii) the issuer or a related person is required to redeem or purchase the stock (within such 20 year period and not subject to such a contingency); (iii) the issuer or a related person has the right to redeem or purchase the stock (which right is exercisable within such 20 year period and not subject to such a contingency) and as of the issue date, it is more likely than not that such right will be exercised, or (iv) the dividend on such stock varies in whole or in part (directly or indirectly) with reference to interest rates, commodity prices, or other similar indices. There are exceptions for certain rights that are exercisable only on the death, disability or mental incompetency of the holder, or only upon the separation from service of a service provider who received the right as reasonable compensation for services, and for certain situations involving publicly traded stock. Nonqualified preferred stock is treated in the same manner as securities under section 351 and thus is not qualified consideration that may be received tax free by a contributing shareholder. Sections 354(a)(2)(C) and 356(e) treat nonqualified preferred stock as taxable consideration if received in exchange for stock by shareholders of a corporation that itself is a party to a reorganization (except to the extent received in exchange for other nonqualified preferred stock); and section 355 contains a similar rule (sec. 355(a)(3)(D)).

However, the proposal does not apply to any exchange in connection with a transaction which is (i) made pursuant to an agreement which was binding on February 6, 2012 and at all times thereafter, (ii) described in a ruling request submitted to the Internal Revenue Service on or before such date, or (iii) described on or before such date in a public announcement or in a filing with the Securities and Exchange Commission.

2. Inclusion of Internal Revenue Service levies as enforceable against thrift savings plan account

Present Law

In general

Levy is the IRS's administrative authority to seize a taxpayer's property, or rights to property, to pay the taxpayer's tax liability.[8] Generally, the IRS is entitled to seize a taxpayer's property by levy if a Federal tax lien has attached to such property,[9] the property is not exempt from levy,[10] the IRS has provided both notice of intention to levy[11] and notice of the right to an administrative hearing (the notice is referred to as a "collections due process notice" or "CDP notice" and the hearing is referred to as the "CDP hearing")[12] at least 30 days before the levy is made. A Federal tax lien arises automatically when: (1) a tax assessment has been made; (2) the taxpayer has been given notice of the assessment stating the amount and demanding payment; and (3) the taxpayer has failed to pay the amount assessed within 10 days after the notice and demand.[13]

The notice of intent to levy is not required if the Secretary finds that collection would be jeopardized by delay. The standard for determining whether jeopardy exists is similar to the standard applicable when determining whether assessment of tax without following the normal deficiency procedures is permitted.[14]

The CDP notice (and pre-levy CDP hearing) is not required if the Secretary finds that collection would be jeopardized by delay or the Secretary has served a levy on a State to collect a Federal tax liability from a State tax refund. In addition, a levy issued to collect Federal employment taxes is excepted from the CDP notice and the pre-levy CDP hearing requirement if

[8] Sec. 6331(a). Levy specifically refers to the legal process by which the IRS orders a third party to turn over property in its possession that belongs to the delinquent taxpayer named in a notice of levy.

[9] *Ibid.*

[10] Sec. 6334.

[11] Sec. 6331(d).

[12] Sec. 6330. The notice and the hearing are referred to collectively as the CDP requirements.

[13] Sec. 6321.

[14] Secs. 6331(d)(3), 6861.

the taxpayer subject to the levy requested a CDP hearing with respect to unpaid employment taxes arising in the two-year period before the beginning of the taxable period with respect to which the employment tax levy is served. In each of these three cases, however, the taxpayer is provided an opportunity for a hearing within a reasonable period of time after the levy.[15]

Federal payment levy program

To help the IRS collect taxes more effectively, the Taxpayer Relief Act of 1997[16] authorized the establishment of the Federal Payment Levy Program ("FPLP"), which allows the IRS to continuously levy up to 15 percent of "specified payments." The term specified payment includes, *inter alia*, any Federal payment other than a payment for which eligibility is based on the income or assets (or both) of the payee.[17]

Under FPLP, the IRS matches its accounts receivable records with Federal payment records maintained by the Department of the Treasury's Financial Management Service ("FMS"), such as certain Social Security benefit and Federal wage records. When these records match, the delinquent taxpayer is provided both the notice of intention to levy and the CDP notice. If the taxpayer does not respond after 30 days, the IRS can instruct FMS to levy the taxpayer's Federal payments. Subsequent payments are continuously levied until such time that the tax debt is paid or the IRS releases the levy.

Thrift Savings Plan

Present law includes an anti-alienation rule which provides that the balance of an employee's Thrift Savings Plan ("TSP") Account is subject to taking for the enforcement of one's obligations, to provide for child support or alimony payments, restitution orders, certain forfeitures, or certain obligations of the Executive Director.[18] The authority for the IRS to levy an employee's TSP account to satisfy tax liabilities is not mentioned in the anti-alienation rule; TSP accounts are not specifically numerated in the code proposals identifying property that is exempt from levy.

Description of Proposal

The proposal amends the statutory proposals governing the TSP to clarify that the anti-alienation proposals therein do not bar the IRS from issuing a notice of levy on a TSP Account.

[15] Sec. 6330(f).

[16] Pub. L. No. 105-34.

[17] Sec. 6331(h)(2). Specified payment also includes certain payments otherwise exempt from levy under section 6334.

[18] 5 U.S.C. sec. 8437(e)(3).

Effective Date

The proposal is effective upon date of enactment.

3. Small issuer exception to tax-exempt interest expense allocation rules for financial institutions

Present Law

Present law disallows a deduction for interest on indebtedness incurred or continued to purchase or carry obligations the interest on which is exempt from tax.[19] In general, an interest deduction is disallowed only if the taxpayer has a purpose of using borrowed funds to purchase or carry tax-exempt obligations; a determination of the taxpayer's purpose in borrowing funds is made based on all of the facts and circumstances.[20]

Financial institutions

In the case of a financial institution, the Code generally disallows that portion of the taxpayer's interest expense that is allocable to tax-exempt interest.[21] The amount of interest that is disallowed is an amount which bears the same ratio to such interest expense as the taxpayer's average adjusted bases of tax-exempt obligations acquired after August 7, 1986, bears to the average adjusted bases for all assets of the taxpayer.

Exception for certain obligations of qualified small issuers

The general rule in section 265(b), denying financial institutions' interest expense deductions allocable to tax-exempt obligations, does not apply to "qualified tax-exempt obligations."[22] Instead, as discussed in the next section, only 20 percent of the interest expense allocable to "qualified tax-exempt obligations" is disallowed.[23] A "qualified tax-exempt obligation" is a tax-exempt obligation that (1) is issued after August 7, 1986, by a qualified small issuer, (2) is not a private activity bond, and (3) is designated by the issuer as qualifying for the exception from the general rule of section 265(b).

A "qualified small issuer" is an issuer that reasonably anticipates that the amount of tax-exempt obligations that it will issue during the calendar year will be $10 million or less.[24] The

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[19] Sec. 265(a).

[20] See Rev. Proc. 72-18, 1972-1 C.B. 740.

[21] Sec. 265(b)(1). A "financial institution" is any person that (1) accepts deposits from the public in the ordinary course of such person's trade or business and is subject to Federal or State supervision as a financial institution or (2) is a corporation described by section 585(a)(2). Sec. 265(b)(5).

[22] Sec. 265(b)(3).

[23] Secs. 265(b)(3)(A), 291(a)(3) and 291(e)(1).

[24] Sec. 265(b)(3)(C).

Code specifies the circumstances under which an issuer and all subordinate entities are aggregated.[25] For purposes of the $10 million limitation, an issuer and all entities that issue obligations on behalf of such issuer are treated as one issuer. All obligations issued by a subordinate entity are treated as being issued by the entity to which it is subordinate. An entity formed (or availed of) to avoid the $10 million limitation and all entities benefiting from the device are treated as one issuer.

Composite issues (i.e., combined issues of bonds for different entities) qualify for the "qualified tax-exempt obligation" exception only if the requirements of the exception are met with respect to (1) the composite issue as a whole (determined by treating the composite issue as a single issue) and (2) each separate lot of obligations that is part of the issue (determined by treating each separate lot of obligations as a separate issue).[26] Thus a composite issue may qualify for the exception only if the composite issue itself does not exceed $10 million, and if each issuer benefitting from the composite issue reasonably anticipates that it will not issue more than $10 million of tax-exempt obligations during the calendar year, including through the composite arrangement.

Special rules providing modifications to qualified small issuer exception for certain issues in 2009 and 2010

With respect to tax-exempt obligations issued during 2009 and 2010, the special rules increased from $10 million to $30 million the annual limit for qualified small issuers.

In addition, in the case of a "qualified financing issue" issued in 2009 or 2010, the special rules applied the $30 million annual volume limitation at the borrower level (rather than at the level of the pooled financing issuer). Thus, for the purpose of applying the requirements of the section 265(b)(3) qualified small issuer exception, the portion of the proceeds of a qualified financing issue that are loaned to a "qualified borrower" that participates in the issue were treated as a separate issue with respect to which the qualified borrower is deemed to be the issuer.

A "qualified financing issue" was any composite, pooled or other conduit financing issue the proceeds of which were used directly or indirectly to make or finance loans to one or more ultimate borrowers all of whom are qualified borrowers. A "qualified borrower" meant (1) a State or political subdivision of a State or (2) an organization described in section 501(c)(3) and exempt from tax under section 501(a). Thus, for example, a $100 million pooled financing issue that was issued in 2009 would qualify for the section 265(b)(3) exception if the proceeds of such issue were used to make four equal loans of $25 million to four qualified borrowers. However, if (1) more than $30 million were loaned to any qualified borrower, (2) any borrower were not a qualified borrower, or (3) any borrower would, if it were the issuer of a separate issue in an amount equal to the amount loaned to such borrower, fail to meet any of the other requirements

[25] Sec. 265(b)(3)(E).

[26] Sec. 265(b)(3)(F).

of section 265(b)(3), the entire $100 million pooled financing issue failed to qualify for the exception.

For purposes of determining whether an issuer meets the requirements of the small issuer exception, under the special rules, qualified 501(c)(3) bonds issued in 2009 or 2010 were treated as if they were issued by the 501(c)(3) organization for whose benefit they were issued (and not by the actual issuer of such bonds). In addition, in the case of an organization described in section 501(c)(3) and exempt from taxation under section 501(a), requirements for "qualified financing issues" were applied as if the section 501(c)(3) organization were the issuer. Thus, in any event, an organization described in section 501(c)(3) and exempt from taxation under section 501(a) was limited to the $30 million per issuer cap for qualified tax exempt obligations described in section 265(b)(3).

<u>Description of Proposal</u>

The proposal extends the special rules providing modifications to the qualified small issuer exception to bonds issued after the date of enactment and before January 1, 2013.

<u>Effective Date</u>

The proposal is effective for obligations issued after the date of its enactment.

4. Modification of alternative minimum tax limitations on tax-exempt bonds

<u>Present Law</u>

Present law imposes an alternative minimum tax ("AMT") on individuals and corporations. AMT is the amount by which the tentative minimum tax exceeds the regular income tax. The tentative minimum tax is computed based upon a taxpayer's alternative minimum taxable income ("AMTI"). AMTI is the taxpayer's taxable income modified to take into account certain preferences and adjustments. One of the preference items is tax-exempt interest on certain tax-exempt bonds issued for private activities (sec. 57(a)(5)). Also, in the case of a corporation, an adjustment based on current earnings is determined, in part, by taking into account 75 percent of items, including tax-exempt interest, that are excluded from taxable income but included in the corporation's earnings and profits (sec. 56(g)(4)(B)).

The American Recovery and Reinvestment Act of 2009 provided that tax-exempt interest on private activity bonds issued in 2009 and 2010 is not an item of tax preference for purposes of the alternative minimum tax and interest on tax exempt bonds issued in 2009 and 2010 is not included in the corporate adjustment based on current earnings. For these purposes, a refunding bond is treated as issued on the date of the issuance of the refunded bond (or in the case of a series of refundings, the original bond).

The Act also provided that tax-exempt interest on private activity bonds issued in 2009 and 2010 to currently refund a private activity bond issued after December 31, 2003, and before January 1, 2009, is not an item of tax preference for purposes of the alternative minimum tax. Also, tax-exempt interest on bonds issued in 2009 and 2010 to currently refund a bond issued after December 31, 2003, and before January 1, 2009, is not included in the corporate adjustment based on current earnings.

Description of Proposal

The proposal provides that interest on bonds issued after date of enactment and before January 1, 2013 is not treated as a tax preference for purposes of the alternative minimum tax.

Effective Date

The proposal applies to interest on bonds issued after date of enactment.

5. Issuance of TRIP Bonds by State infrastructure banks

Present Law

There are no Code proposals for the issuance of transportation and regional infrastructure project bonds.

Description of Proposal

The proposal amends Title 23 to provide that a State, through a State infrastructure bank, may issue "TRIP" bonds and deposit the proceeds from such bonds into a TRIP bond account of the bank. A "TRIP bond" means any bond issued as part of an issue if (1) 100 percent of the available project proceeds of such issue are to be used for expenditures incurred after the date of enactment for one or more qualified projects pursuant to an allocation of such proceeds to such project or projects by a State infrastructure bank, (2) the bond is issued by a State infrastructure bank and is in registered form (within the meaning of section 149 of the Internal Revenue Code), (3) the State infrastructure bank designates such bond for purposes of the proposal and (4) the term of each bond that is part of such issue does not exceed 30 years. A "qualified project" means the capital improvements to any transportation infrastructure project of any governmental unit or other person, including roads, bridges, rail and transit systems, ports and inland waterways proposed and approved by a State infrastructure bank, but does not include costs of operations or maintenance with respect to such project.

The proposal requires a State to develop a transparent and competitive process for the award of funds deposited into the TRIP bond account that considers the impact of qualified projects on the economy, the environment, state of good repair and equity. The requirements of any Federal law, including title 23 and titles 40 and 49, which would otherwise apply to projects to which the United States is a party or to funds made available under such law and projects assisted with those funds shall apply to (1) funds made available under the TRIP bond account for similar qualified projects and (2) similar qualified projects assisted through the use of such funds.

Effective Date

The proposal is effective on the date of enactment

6. Parity for qualified transportation fringe benefits

Present Law

Qualified transportation fringe benefits provided by an employer are excluded from an employee's gross income for income tax purposes and from an employee's wages for payroll tax purposes.[27] Qualified transportation fringe benefits include parking, transit passes, vanpool benefits, and qualified bicycle commuting reimbursements. No amount is includible in the income of an employee merely because the employer offers the employee a choice between cash and qualified transportation fringe benefits (other than a qualified bicycle commuting reimbursement). Qualified transportation fringe benefits also include a cash reimbursement by an employer to an employee. In the case of transit passes, however, a cash reimbursement is considered a qualified transportation fringe benefit only if a voucher or similar item which may be exchanged only for a transit pass is not readily available for direct distribution by the employer to the employee.

Prior to February 17, 2009, the amount that could be excluded as qualified transportation fringe benefits was limited to $100 per month in combined vanpooling and transit pass benefits and $175 per month in qualified parking benefits. All limits are adjusted annually for inflation, using 1998 as the base year (for 2012 the limits are $125 and $240, respectively). The American Recovery and Reinvestment Act of 2009,[28] however, provided parity in qualified transportation fringe benefits by temporarily increasing the monthly exclusion for employer-provided vanpool and transit pass benefits to the same level as the exclusion for employer-provided parking, effective for months beginning on or after the date of enactment (February 17, 2009) and before January 1, 2011. The Tax Relief, Unemployment Insurance Reauthorization, and Job Creation Act of 2010[29] extended the parity in qualified transportation fringe benefits through December 31, 2011.

Effective January 1, 2012, the amount that could be excluded as qualified transportation fringe benefits is limited to $125 per month in combined vanpooling and transit pass benefits and $240 per month in qualified parking benefits.

Description of Proposal

The proposal extends the parity in qualified transportation fringe benefits for the entire 2012 taxable year.

Effective Date

The proposal is effective on date of enactment.

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[27] Secs. 132(f), 3121(b)(2), and 3306(b)(16) and 3401(a)(19).

[28] Pub. L. No. 111-5.

[29] Pub. L. No. 111-312.

7. Modification of required distribution rules for pension plans

Present Law

Minimum distribution rules apply to employer sponsored tax-favored retirement plans and individual retirement arrangements. In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date and a minimum amount must be distributed each year. Minimum distribution rules also apply to benefits payable with respect to an employee or IRA owner who has died. The regulations under section 401(a)(9) provide a methodology for calculating the required minimum distribution from an individual account under a defined contribution plan or from an IRA. In the case of annuity payments under a defined benefit plan or an annuity contract, the regulations provide requirements that the annuity stream of payments must satisfy. Failure to comply with the minimum distribution requirement results in an excise tax imposed on the individual who was required to be the distributee equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived in certain cases.

Required beginning date

For traditional IRAs, the required beginning date is April 1 following the calendar year in which the employee or IRA owner attains age 70½. For employer-sponsored tax-favored retirement plans, for an employee other than an employee who is a five-percent owner in the year the employee attains age 70½, the employee's required beginning date is April 1 after the later of the calendar year in which the employee attains age 70½ or retires. For an employee who is a five-percent owner under an employer-sponsored tax-favored retirement plan in the year the employee attains age 70½, the required beginning date is the same as for IRAs even if the employee continues to work past age 70½.

Lifetime rules

While an employee or IRA owner is alive, distributions of the individual's interest are required to be made (in accordance with regulations) over the life or life expectancy of the employee or IRA owner, or over the joint lives or joint life expectancy of the employee or IRA owner and a designated beneficiary.[30] For defined contribution plans and IRAs, the required minimum distribution for each year is determined by dividing the account balance as of the end of the prior year by a distribution period which, while the employee or IRA owner is alive, is the factor from the uniform lifetime table included in the Treasury regulations.[31] This table is based on the joint life and last survivor expectancy of the individual and a hypothetical beneficiary 10 years younger.

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[30] Sec. 401(a)(9)(A).

[31] Treas. Reg. sec. 1.401(a)(9)-5. For an individual with a spouse as designated beneficiary who is more than 10 years younger (and thus the number of years in the couple's joint life and last survivor expectancy is greater than the uniform lifetime table), the joint life expectancy and last survivor expectancy of the couple (calculated using the table in the regulations) is used.

Distributions after death

Payments over a distribution period

The after death rules vary depending on (1) whether an employee or IRA owner dies on or after the required beginning date or before the required beginning date, and (2) whether there is a designated beneficiary for the benefit. Under the regulations, a designated beneficiary is an individual designated as a beneficiary under the plan.[32] Similar to the lifetime rules, for defined contribution plans and IRAs, the required minimum distribution for each year after the death of the employee or IRA owner is generally determined by dividing the account balance as of the end of the prior year by a distribution period.

Under section 401(a)(9)(B)(i), if an employee or IRA owner dies on or after the required beginning date, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. Under the regulations, for individual accounts, if there is a designated beneficiary, the distribution period is the beneficiary's life expectancy calculated using the life expectancy table in the regulations, calculated in the year after the year of the death.[33] If there is no designated beneficiary, the distribution period is equal to the remaining years of the employee or IRA owner's life, as of the year of death.[34]

If an employee or IRA owner dies before the required beginning date and any portion of the benefit is payable to a designated beneficiary, distributions are permitted to begin within one year of the employee's (or IRA owner's) death (or such later date as prescribed in regulations) and to be paid (in accordance with regulations) over the life or life expectancy of the designated beneficiary.[35] Under the regulations, for individual accounts, the distribution period is measured by the designated beneficiary's life expectancy, calculated in the same manner as if the individual dies on or after the required beginning date.[36]

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[32] Treas. Reg. sec. 1.401(a)(9)-4, A-1. The individual need not be named as long as the individual is identifiable under the terms of the plan. There are special rules for multiple beneficiaries and for trusts named as beneficiary (where the beneficiaries of the trust are individuals). However, if an individual is named as beneficiary through the employee or IRA owner's will or the estate is named as beneficiary, there is no designated beneficiary for purposes of the minimum distribution requirements.

[33] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

[34] Treas. Reg. sec. 1.401(a)(9)-5, A-5(a).

[35] Special rules apply if the beneficiary of the employee or IRA owner is the individual's surviving spouse. In that case, distributions are not required to commence until the year in which the employee or IRA owner would have attained age 70½. If the surviving spouse dies before the employee or IRA owner would have attained age 70 ½, the after-death rules for death before distributions have begun are applied as though the spouse were the employee or IRA owner.

[36] Treas. Reg. sec. 1.401(a)(9)-5, A-5(b).

In all cases where distribution after death is based on life expectancy (either the remaining life expectance of the employee or IRA owner or a designated beneficiary), the distribution period generally is fixed at death and then reduced by one for each year that elapses after the year in which it is calculated. If the designated beneficiary dies during the distribution period, distributions continue to the subsequent beneficiaries over the remaining years in the distribution period.[37]

Five-year rule

If an employee or IRA owner dies before the required beginning date and there is no designated beneficiary, then the entire remaining interest of the employee or IRA owner must generally be distributed by the end of the fifth year following the individual's death.[38]

Defined benefit plans and annuity distributions

The regulations provide rules for annuity distributions from a defined benefit plan or an annuity purchased from an insurance company paid over life or life expectancy. Annuity distributions are generally required to be nonincreasing with certain exceptions, which include, for example, increases to the extent of certain specified cost of living indexes, a constant percentage increase (for a qualified plan, the constant percentage cannot exceed five percent per year), certain accelerations of payments, increases to reflect when an annuity is converted to a single life annuity after the death of the beneficiary under a joint and survivor annuity or after termination of the survivor annuity under a QDRO.[39] If distributions are in the form of a joint and survivor annuity and the survivor annuitant both is not the surviving spouse and is younger than the employee or IRA owner, the survivor annuitant is limited to a percentage of the life annuity benefit for the employee or IRA owner.[40] The survivor benefit as a percentage of the benefit of the primary annuitant is required to be smaller (but not required to be less than 52 percent) as the difference in the ages of the primary annuitant and the survivor annuitant become greater.

Description of Proposal

Required beginning date

Under the proposal, if an employee becomes a five-percent owner after age 70½ but before retiring and thus before the employee's required beginning date with respect to tax

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[37] If the distribution period is based on the surviving spouse's life expectancy (whether the employee or IRA owner's death is before or after the required beginning date), the spouse's life expectancy generally is recalculated each year while the spouse is alive and then fixed the year after the spouse's death.

[38] Treas. Reg. sec. 1.401(a)(9)-3, A-2.

[39] Treas. Reg. sec. 1.401(a)(9)-6, A-14.

[40] Treas. Reg. sec. 1.401(a)(9)-6, A-2.

favored retirement plans of the employee's employer, the required beginning date for that employee becomes April 1 following the year that the employee becomes a five-percent owner.

Other than the modification to the required beginning date for five-percent owners, the proposal makes no change to the required minimum distribution rule during the lifetime of the employee or IRA owner. Thus, for example, the proposal is not expected to result in a change in the regulations under section 401(a)(9) for required minimum distributions during the lifetime of the employee or IRA owner under which the required minimum distribution for each year is generally determined by dividing the account balance as of the end of the prior year by a distribution period which is the number corresponding to the employee or IRA owner's age for the year from the uniform lifetime table included in the Treasury regulations.

After death rules

Under the proposal, the five-year rule is the general rule for all distributions after death (regardless of whether the employee or IRA owner dies before, on, or after the required beginning date) unless the beneficiary is an eligible beneficiary as defined in the proposal. Eligible beneficiaries include any beneficiary who, as of the date of death, is the surviving spouse of the employee or IRA owner, is disabled, is a chronically ill individual, is an individual who is not more than 10 years younger than the employee or IRA owner, or is a child who has not reached the age of majority. For these beneficiaries, the exception to the five-year rule (for death before the required beginning date) applies whether or not the IRA owner or employee dies before or after the required beginning date. That rule allows distributions over the life or life expectancy of the beneficiary beginning in the year following the year of death.

However, unlike present law, under the proposal, the five-year rule applies after the death of the eligible beneficiary. Thus for example, if a disabled child is an eligible beneficiary of a parent who dies when the child is age 20 and the child dies at age 30, even though 52.1 years remain in the life expectancy of the child calculated for the child's age (21) in the year after the employee's death, the disabled child's remaining beneficiary interest must be distributed by the end of the fifth year following the death of the disabled child. If a child is an eligible beneficiary based on having not reached the age of majority before the employee or IRA owner's death, the five-year rule applies beginning with the date that the child reaches the age of majority. Thus the child's entire interest must be distributed by the end of the fifth year following that date.

Definition of disabled and chronically ill individual

Under the proposal, the definition of disabled in section 72(m)(7) is incorporated by reference. Under this definition disabled means unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment that can be expected to end in death or to be for long-continued and indefinite duration. Under section 72(m)(7), an individual is not considered to be disabled unless proof of the disability is furnished in such form and manner as the Secretary may require.

Under the proposal, the definition of chronically ill individual in section 7702B(c)(2) is incorporated by reference with a modification. Under this definition a chronically ill individual is any individual who (1) is unable to perform (without substantial assistance from another individual) at least two activities of daily living for an indefinite period (expected to be lengthy in nature)[41] due to a loss of functional capacity, (2) has a level of disability similar (as determined under regulations prescribed by the Secretary in consultation with the Secretary of Health and Human Services) to the level of disability described above requiring assistance with daily living based on loss of functional capacity, or (3) requires substantial supervision to protect the individual from threats to health and safety due to severe cognitive impairment. The activities of daily living for which assistance is needed for purposes of determining loss of functional capacity are eating, toileting, transferring, bathing, dressing, and continence.

Effective Date

Required beginning date change for five-percent owners

For the proposal changing the definition of required beginning date for employees who become five-percent owners after age 70½, if an employee became a five-percent owner with respect to a plan year ending before January 1, 2012, and the employee has not retired before 2013, the employee is treated as having become a five-percent owner in 2013. Thus, the employee's required beginning date is April 1, 2014. Otherwise, the proposal is effective upon date of enactment without regard to whether the employee became a five-percent owner before, on, or after the date of enactment.

Required distributions after death

For determining minimum required distributions after the death of an employee or IRA owner, the proposal is generally effective for distributions with respect to employees or IRA owners who die after December 31, 2012.

In the case of an employee who dies before January 1, 2013, if the designated beneficiary of the employee or IRA owner dies after December 31, 2012, the proposal applies to any beneficiary of the designated beneficiary as though the designated beneficiary were an eligible beneficiary. Thus, the entire interest must be distributed by the end of the fifth year after the death of the designated beneficiary.

In the case of an employee who dies after December 31, 2012, the proposal does not apply to a qualified annuity which is a binding annuity contract in effect on the date of the enactment and at all times thereafter. To be a qualified annuity, the annuity must be a commercial annuity (as defined in section 3405(e)(6)) or an annuity payable by a defined benefit plan, and (2) an annuity under which the annuity payments are substantially equal periodic payments (not less frequently than annually) over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary) in accordance with the required minimum distribution regulations for annuity payments (as in effect before enactment of this proposal). In addition to these requirements, to be a qualified annuity, annuity payments to the employee (or IRA owner) must have begun before January 1, 2013, and the employee (or IRA

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[41] Section 7702B(c) only requires this period to be at least 90 days.

owner) must have made an irrevocable election before that date as to the method and amount of the annuity payments to the employee or any designated beneficiaries. Alternatively, if an annuity is not a qualified annuity solely based on annuity payments not having begun irrevocably before January 1, 2013, an annuity can be a qualified annuity if the employee or IRA owner has made an irrevocable election before the date of enactment as to the method and amount of the annuity payments to the employee or any designated beneficiaries.