

**TECHNICAL EXPLANATION OF H.R. 4,
THE “PENSION PROTECTION ACT OF 2006,”
AS PASSED BY THE HOUSE ON JULY 28, 2006,
AND AS CONSIDERED BY THE SENATE
ON AUGUST 3, 2006**

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 technical explanation of the “Pension Protection Act of 2006,” as passed by the House of Representatives on July 28, 2006, and as considered by the Senate on August 3, 2006.

¹ This document may be cited as follows: Joint Committee on Taxation, *Technical Explanation of H.R. 4, the “Pension Protection Act of 2006,” as Passed by the House on July 28, 2006, and as Considered by the Senate on August 3, 2006* (JCX-38-06), August 3, 2006.

TITLE I: REFORM OF FUNDING RULES FOR SINGLE-EMPLOYER DEFINED BENEFIT PENSION PLANS²

A. Minimum Funding Standards for Single-Employer Defined Benefit Pension Plans (secs. 302-308 of ERISA, and sec. 412 and new sec. 430 of the Code)

Present Law

In general

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

General minimum funding rules

Funding standard account

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

In determining plan funding under an actuarial cost method, a plan’s actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions

² Some provisions that are identical or similar to the pension provisions in the bill were contained in other bills reported by the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor and Pensions, or passed by the House or the Senate during the 109th Congress. These bills include H.R. 2830, S. 1953, and S. 1783.

³ Multiemployer defined benefit pension plans are also subject to the minimum funding requirements, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans. Governmental plans and church plans are generally exempt from the minimum funding requirements.

typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If the plan's actual unfunded liabilities are less than those anticipated by the actuary on the basis of these assumptions, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. Experience gains and losses for a year are generally amortized as credits or charges to the funding standard account over five years.

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

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

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

Credit balances

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

Funding methods and general concepts

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting

of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

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

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

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

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

In applying the funding rules, all costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would

be determined if each assumption and method were reasonable. In addition, the assumptions are required to offer the actuary's best estimate of anticipated experience under the plan.⁴

Additional contributions for underfunded plans

In general

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

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

The deficit reduction contribution is generally the sum of (1) the “unfunded old liability amount,” (2) the “unfunded new liability amount,” and (3) the expected increase in current

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

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

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

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

liability due to benefits accruing during the plan year.⁸ The “unfunded old liability amount” is the amount needed to amortize certain unfunded liabilities under 1987 and 1994 transition rules. The “unfunded new liability amount” is the applicable percentage of the plan’s unfunded new liability. Unfunded new liability generally means the unfunded current liability of the plan (i.e., the amount by which the plan’s current liability exceeds the actuarial value of plan assets), but determined without regard to certain liabilities (such as the plan’s unfunded old liability and unpredictable contingent event benefits). The applicable percentage is generally 30 percent, but decreases by .40 of one percentage point for each percentage point by which the plan’s funded current liability percentage exceeds 60 percent. For example, if a plan’s funded current liability percentage is 85 percent (i.e., it exceeds 60 percent by 25 percentage points), the applicable percentage is 20 percent (30 percent minus 10 percentage points (25 multiplied by .4)).⁹

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

Required interest rate and mortality table

Specific interest rate and mortality assumptions must be used in determining a plan’s current liability for purposes of the special funding rule. For plans years beginning before January 1, 2004, and after December 31, 2005, the interest rate used to determine a plan’s current liability must be within a permissible range of the weighted average of the interest rates on 30-year Treasury securities for the four-year period ending on the last day before the plan year begins.¹⁰ The permissible range is generally from 90 percent to 105 percent (120 percent for plan years beginning in 2002 or 2003).¹¹ The interest rate used under the plan generally must be consistent with the assumptions which reflect the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.¹²

⁸ The deficit reduction contribution may also include an additional amount as a result of the use of a new mortality table prescribed by the Secretary of the Treasury in determining current liability for plan years beginning after 2006, as described below.

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

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

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

¹² Code sec. 412(b)(5)(B)(iii)(II); ERISA sec. 302(b)(5)(B)(iii)(II). Under Notice 90-11, 1990-1 C.B. 319, the interest rates in the permissible range are deemed to be consistent with the assumptions

Under the Pension Funding Equity Act of 2004 (“PFEA 2004”),¹³ a special interest rate applies in determining current liability for plan years beginning in 2004 or 2005.¹⁴ For these years, the interest rate used must be within a permissible range of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins. The permissible range for these years is from 90 percent to 100 percent. The interest rate is to be determined by the Secretary of the Treasury on the basis of two or more indices that are selected periodically by the Secretary and are in the top three quality levels available.

In determining current liability, the 1983 Group Annuity Mortality Table has been used since 1995.¹⁵ Under present law, the Secretary of the Treasury may prescribe other tables to be used based on the actual experience of pension plans and projected trends in such experience. In addition, the Secretary of the Treasury is required to periodically review (at least every five years) any tables in effect and, to the extent the Secretary determines necessary, update such tables to reflect the actuarial experience of pension plans and projected trends in such experience.¹⁶ Under Prop. Treas. Reg. 1.412(l)(7)-1, beginning in 2007, RP-2000 Mortality Tables are used with improvements in mortality (including future improvements) projected to the current year and with separate tables for annuitants and nonannuitants.¹⁷

Other rules

Full funding limitation

No contributions are required under the minimum funding rules in excess of the full funding limitation. The full funding limitation is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets.¹⁸ However, the full funding limitation may not be less

reflecting the purchase rates that would be used by insurance companies to satisfy the liabilities under the plan.

¹³ Pub. L. No. 108-218 (2004).

¹⁴ In addition, under PFEA 2004, if certain requirements are met, reduced contributions under the deficit reduction contribution rules apply for plan years beginning after December 27, 2003, and before December 28, 2005, in the case of plans maintained by commercial passenger airlines, employers primarily engaged in the production or manufacture of a steel mill product or in the processing of iron ore pellets, or a certain labor organization.

¹⁵ Rev. Rul. 95-28, 1995-1 C.B. 74. Separate mortality tables are required to be used with respect to disabled participants.

¹⁶ Code sec. 412(l)(7)(C)(ii)(III); ERISA sec. 302(d)(7)(C)(ii)(III).

¹⁷ Separate tables continue to apply with respect to disabled participants.

¹⁸ For plan years beginning before 2004, the full funding limitation was generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) a

than the excess, if any, of 90 percent of the plan's current liability (including the expected increase in current liability due to benefits accruing during the plan year) over the actuarial value of plan assets. In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability under the full funding limitation may be based on projected future benefits, including future salary increases.

Timing of plan contributions

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

In the case of a plan with a funded current liability percentage of less than 100 percent for the preceding plan year, estimated contributions for the current plan year must be made in quarterly installments during the current plan year.¹⁹ The amount of each required installment is generally 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.²⁰ If a required installment is not made, interest applies for the period of underpayment at a rate of the greater of (1) 175 percent of the Federal mid-term rate, or (2) the plan rate.

Funding waivers

Within limits, the Secretary of the Treasury is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year (a "waived funding deficiency").²¹ A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship and if requiring the contribution would be adverse to the interests of plan participants in the aggregate. Generally, no more than three waivers may be granted within any period of 15 consecutive plan years.

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

¹⁹ Code sec. 412(m); ERISA sec. 302(e).

²⁰ If quarterly contributions are required with respect to a plan, the amount of a quarterly installment must also be sufficient to cover any shortfall in the plan's liquid assets (a "liquidity shortfall").

²¹ Code sec. 412(d); ERISA sec. 303. Under similar rules, the amortization period applicable to an unfunded past service liability or loss may also be extended.

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

Failure to make required contributions

An employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.²² The excise tax is 10 percent of the amount of the accumulated funding deficiency. In addition, a tax of 100 percent may be imposed if the accumulated funding deficiency is not corrected within a certain period.

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

Explanation of Provision

Interest rate required for plan years beginning in 2006 and 2007

For plan years beginning after December 31, 2005, and before January 1, 2008, the provision applies the present-law funding rules, with an extension of the interest rate applicable in determining current liability for plan years beginning in 2004 and 2005. Thus, in determining current liability for funding purposes for plan years beginning in 2006 and 2007, the interest rate used must be within the permissible range (90 to 100 percent) of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins.

Funding rules for plan years beginning after 2007 - in general

For plan years beginning after December 31, 2007, in the case of single-employer defined benefit plans, the provision repeals the present-law funding rules (including the requirement that a funding standard account be maintained) and provides a new set of rules for determining minimum required contributions.²³ Under the provision, the minimum required contribution to a single-employer defined benefit pension plan for a plan year generally depends on a comparison of the value of the plan's assets with the plan's funding target and target normal cost. As described in more detail below, under the provision, credit balances generated under present law

²² Code sec. 4971. An excise tax applies also if a quarterly installment is less than the amount required to cover the plan's liquidity shortfall.

²³ A delayed effective date applies to certain plans as discussed in Items C, D and E below. Changes to the funding rules for multiemployer plans are discussed in Title II below. Governmental plans and church plans continue to be exempt from the funding rules to the extent provided under present law.

are carried over (into a “funding standard carryover balance”) and generally may be used in certain circumstances to reduce otherwise required minimum contributions. In addition, as described more fully below, contributions in excess of the minimum contributions required under the provision for plan years beginning after 2007 generally are credited to a prefunding balance that may be used in certain circumstances to reduce otherwise required minimum contributions. To facilitate the use of such balances to reduce minimum required contributions, while avoiding use of such balances for more than one purpose, in some circumstances the value of plan assets is reduced by the prefunding balance and/or the funding standard carryover balance.

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

<i>If:</i>	<i>The minimum required contribution is:</i>
the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) is less than the funding target,	the sum of: (1) target normal cost; (2) any shortfall amortization charge; and (3) any waiver amortization charge.
the value of plan assets (reduced by any prefunding balance and funding standard carryover balance) equals or exceeds the funding target,	the target normal cost, reduced (but not below zero) by the excess of (1) the value of plan assets (reduced by any prefunding balance and funding standard carryover balance), over (2) the funding target.

Under the provision, a plan’s funding target is the present value of all benefits accrued or earned as of the beginning of the plan year. A plan’s target normal cost for a plan year is the present value of benefits expected to accrue or be earned during the plan year. A shortfall amortization charge is generally the sum of the amounts required to amortize any shortfall amortization bases for the plan year and the six preceding plan years. A shortfall amortization base is generally required to be established for a plan year if the plan has a funding shortfall for a plan year.²⁴ A shortfall amortization base may be positive or negative, i.e., an offsetting amortization base is established for gains. In general, a plan has a funding shortfall if the plan’s funding target for the year exceeds the value of the plan’s assets (reduced by any prefunding balance and funding standard carryover balance). A waiver amortization charge is the amount required to amortize a waived funding deficiency.

The provision specifies the interest rates and mortality table that must be used in determining a plan’s target normal cost and funding target, as well as certain other actuarial

²⁴ Under a special rule, discussed below, a shortfall amortization base does not have to be established if the value of a plan’s assets (reduced by any prefunding balance, but only if the employer elects to use any portion of the prefunding balance to reduce required contributions for the year) is at least equal to the plan’s funding target for the plan year.

assumptions, including special assumptions (“at-risk” assumptions) for a plan in at-risk status. A plan is in at-risk status for a year if the value of the plan’s assets (reduced by any prefunding and funding standard carryover balances) for the preceding year was less than (1) 80 percent of the plan’s funding target determined without regard to the at-risk assumptions, and (2) 70 percent of the plan’s funding target determined using the at-risk assumptions. Under a transition rule, instead of 80 percent, the following percentages apply: 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010.

Target normal cost

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

If the value of a plan’s assets (reduced by any funding standard carryover balance and prefunding balance) exceeds the plan’s funding target for a plan year, the minimum required contribution for the plan year is target normal cost reduced by such excess (but not below zero).

Funding target and shortfall amortization charges

In general

If the value of a plan’s assets (reduced by any funding standard carryover balance and prefunding balance) is less than the plan’s funding target for a plan year, so that the plan has a funding shortfall,²⁵ the minimum required contribution is generally increased by a shortfall amortization charge. As discussed more fully below, the shortfall amortization charge is the aggregate total (not less than zero) of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for the plan year and the six preceding plan years.

Funding target

A plan’s funding target for a plan year is the present value of all benefits accrued or earned under the plan as of the beginning of the plan year. For this purpose, all benefits (including early retirement or similar benefits) are taken into account. Benefits accruing in the

²⁵ Under a special rule, in determining a plan’s funding shortfall, the value of plan assets is not reduced by any funding standard carryover balance or prefunding balance if, with respect to the funding standard carryover balance or prefunding balance, there is in effect for the year a binding written with the Pension Benefit Guaranty Corporation which provides that such balance is not available to reduce the minimum required contribution for the plan year.

plan year are not taken into account in determining the plan's funding target, regardless of whether the valuation date for the plan year is later than the first day of the plan year.²⁶

Shortfall amortization charge

The shortfall amortization charge for a plan year is the aggregate total (not less than zero) of the shortfall amortization installments for the plan year with respect to any shortfall amortization bases for that plan year and the six preceding plan years. The shortfall amortization installments with respect to a shortfall amortization base for a plan year are the amounts necessary to amortize the shortfall amortization base in level annual installments over the seven-plan-year period beginning with the plan year. The shortfall amortization installment with respect to a shortfall amortization base for any plan year in the seven-year period is the annual installment determined for that year for that shortfall amortization base. Shortfall amortization installments are determined using the appropriate segment interest rates (discussed below).

Shortfall amortization base and phase-in of funding target

A shortfall amortization base is determined for a plan year based on the plan's funding shortfall for the plan year. The funding shortfall is the amount (if any) by which the plan's funding target for the year exceeds the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance).

The shortfall amortization base for a plan year is (1) the plan's funding shortfall, minus (2) the present value, determined using the segment interest rates (discussed below), of the aggregate total of the shortfall amortization installments and waiver amortization installments that have been determined for the plan year and any succeeding plan year with respect to any shortfall amortization bases and waiver amortization bases for preceding plan years.

A shortfall amortization base may be positive or negative, depending on whether the present value of remaining installments with respect to prior year amortization bases is more or less than the plan's funding shortfall. In either case, the shortfall amortization base is amortized over seven years. Shortfall amortization installments for a particular plan year with respect to positive and negative shortfall amortization bases are netted in determining the shortfall amortization charge for the plan year, but the resulting shortfall amortization charge cannot be less than zero. Thus, negative amortization installments may not offset waiver amortization installments or normal cost.

Under a special rule, a shortfall amortization base does not have to be established for a plan year if the value of a plan's assets (reduced by any prefunding balance, but only if the employer elects to use any portion of the prefunding balance to reduce required contributions for the year) is at least equal to the plan's funding target for the plan year. For purposes of the special rule, a transition rule applies for plan years beginning after 2007 and before 2011. The transition rule does not apply to a plan that (1) is not in effect for 2007, or (2) is subject to the

²⁶ Benefits accruing during the plan year are taken into account in determining normal cost for the plan year.

present-law deficit reduction contribution rules for 2007 (i.e., a plan covering more than 100 participants and with a funded current liability below the applicable threshold).

Under the transition rule, a shortfall amortization base does not have to be established for a plan year during the transition period if the value of plan assets (reduced by any prefunding balance, but only if the employer elects to use the prefunding balance to reduce required contributions for the year) for the plan year is at least equal to the applicable percentage of the plan's funding target for the year. The applicable percentage is 92 percent for 2008, 94 percent for 2009, and 96 percent for 2010. However, the transition rule does not apply to a plan for any plan year after 2008 unless, for each preceding plan year after 2007, the plan's shortfall amortization base was zero (i.e., the plan was eligible for the special rule each preceding year).

Early deemed amortization of funding shortfalls for preceding years

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

Waiver amortization charges

The provision retains the present-law rules under which the Secretary of the Treasury may waive all or a portion of the contributions required under the minimum funding standard for a plan year (referred to as a "waived funding deficiency").²⁷ If a plan has a waived funding deficiency for any of the five preceding plan years, the minimum required contribution for the plan year is increased by the waiver amortization charge for the plan year.

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

If a plan's funding shortfall for a plan year is zero (i.e., the value of the plan's assets, reduced by any funding standard carryover balance and prefunding balance, is at least equal to the plan's funding target for the year), any waiver amortization bases for preceding plan years

²⁷ In the case of single-employer plans, the provision repeals the present-law rules under which the amortization period applicable to an unfunded past service liability or loss may be extended.

are eliminated. That is, for purposes of determining any waiver amortization charges for that year and succeeding years, the waiver amortization bases for all preceding years (and all waiver amortization installments determined with respect to such bases) are reduced to zero.

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

Interest rates

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

The corporate bond yield curve used for this purpose is to be prescribed on a monthly basis by the Secretary of the Treasury and reflect the average, for the 24-month period ending with the preceding month, of yields on investment grade corporate bonds with varying maturities and that are in the top three quality levels available. The yield curve should reflect the average of the rates on all bonds in the top three quality levels on which the yield curve is based.

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

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

Solely for purposes of determining minimum required contributions, in lieu of the segment rates described above, an employer may elect to use interest rates on a yield curve based on the yields on investment grade corporate bonds for the month preceding the month in which the plan year begins (i.e., without regard to the 24-month averaging described above). Such an election may be revoked only with consent of the Secretary of the Treasury.

The provision provides a transition rule for plan years beginning in 2008 and 2009 (other than for plans first effective after December 31, 2007). Under this rule, for plan years beginning in 2008, the first, second, or third segment rate with respect to any month is the sum of: (1) the

product of the segment rate otherwise determined for the month, multiplied by 33- $\frac{1}{3}$ percent; and (2) the product of the applicable long-term corporate bond rate,²⁸ multiplied by 66- $\frac{2}{3}$ percent. For plan years beginning in 2009, the first, second, or third segment rate with respect to any month is the sum of: (1) the product of the segment rate otherwise determined for the month, multiplied by 66- $\frac{2}{3}$ percent; and (2) the product of applicable long-term corporate bond rate multiplied by 33- $\frac{1}{3}$ percent. An employer may elect not to have the transition rule apply with respect to a plan. Such an election may be revoked only with consent of the Secretary of the Treasury.

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

Mortality table

Under the provision, the Secretary of the Treasury is directed to prescribe by regulation the mortality tables to be used in determining present value or making any computation under the funding rules.²⁹ Such tables are to be based on the actual experience of pension plans and projected trends in such experience. In prescribing tables, the Secretary is to take into account results of available independent studies of mortality of individuals covered by pension plans. In addition, the Secretary is required (at least every 10 years) to revise any table in effect to reflect the actual experience of pension plans and projected trends in such experience.

The provision also provides for the use of a separate mortality table upon request of the plan sponsor and approval by the Secretary of the Treasury in accordance with procedures described below. In order for the table to be used: (1) the table must reflect the actual experience of the pension plans maintained by the plan sponsor and projected trends in general mortality experience, and (2) there must be a sufficient number of plan participants, and the pension plans must have been maintained for a sufficient period of time, to have credible information necessary for that purpose. A separate mortality table can be a mortality table constructed by the plan's enrolled actuary from the plan's own experience or a table that is an adjustment to the table prescribed by the Secretary which sufficiently reflects the plan's experience. Except as provided by the Secretary, a separate table may not be used for any plan unless (1) a separate table is established and used for each other plan maintained by the plan sponsor and, if the plan sponsor is a member of a controlled group, each member of the

²⁸ The applicable long-term corporate bond rate is a rate that is from 90 to 100 percent of the weighted average of the rates of interest on amounts invested conservatively in long-term investment-grade corporate bonds during the four-year period ending on the last day before the plan year begins as determined by the Secretary under the method in effect for 2007.

²⁹ As under present law, separate mortality tables are required to be used with respect to disabled participants.

controlled group,³⁰ and (2) the requirements for using a separate table are met with respect to the table established for each plan, taking into account only the participants of that plan, the time that plan has been in existence, and the actual experience of that plan. In general, a separate plan may be used during the period of consecutive year plan years (not to exceed 10) specified in the request. However, a separate mortality table ceases to be in effect as of the earlier of (1) the date on which there is a significant change in the participants in the plan by reason of a plan spinoff or merger or otherwise, or (2) the date on which the plan actuary determines that the table does not meet the requirements for being used.

A plan sponsor must submit a separate mortality table to the Secretary for approval at least seven months before the first day of the period for which the table is to be used. A mortality table submitted to the Secretary for approval is treated as in effect as of the first day of the period unless the Secretary, during the 180-day period beginning on the date of the submission, disapproves of the table and provides the reasons that the table fails to meet the applicable criteria. The 180-day period is to be extended upon mutual agreement of the Secretary and the plan sponsor.

Other assumptions

Under the provision, in determining any present value or making any computation, the probability that future benefits will be paid in optional forms of benefit provided under the plan must be taken into account (including the probability of lump-sum distributions determined on the basis of the plan's experience and other related assumptions). The assumptions used to determine optional forms of benefit under a plan may differ from the assumptions used to determine present value for purposes of the funding rules under the provision. Differences in the present value of future benefit payments that result from the different assumptions used to determine optional forms of benefit under a plan must be taken into account in determining any present value or making any computation for purposes of the funding rules.

The provision generally does not require other specified assumptions to be used in determining the plan's target normal cost and funding target except in the case of at-risk plans (discussed below). However, similar to present law, the determination of present value or other computation must be made on the basis of actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), and which, in combination, offer the actuary's best estimate of anticipated experience under the plan.³¹

³⁰ For example, the Secretary may deem it appropriate to provide an exception in the case of a small plan.

³¹ The provision retains the present-law rule under which certain changes in actuarial assumptions that decrease the liabilities of an underfunded single-employer plan must be approved by the Secretary of the Treasury.

Special assumptions for at-risk plans

The provision applies special assumptions (“at-risk” assumptions) in determining the funding target and normal cost of a plan in at-risk status. Whether a plan is in at-risk status for a plan year depends on its funding target attainment percentage for the preceding year. A plan’s funding target attainment percentage for a plan year is the ratio, expressed as a percentage, that the value of the plan’s assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan’s funding target for the year. For this purpose, the plan’s funding target is determined using the actuarial assumptions for plans that are not at-risk.

Under the provision, a plan is in at-risk status for a year if, for the preceding year: (1) the plan’s funding target attainment percentage, determined without regard to the at-risk assumptions, was less than 80 percent (with a transition rule discussed below), and (2) the plan’s funding target attainment percentage, determined using the at-risk assumptions (without regard to whether the plan was in at-risk status for the preceding year), was less than 70 percent. Under a transition rule applicable for plan years beginning in 2008, 2009, and 2010, instead of 80 percent, the following percentages apply: 65 percent for 2008, 70 percent for 2009, and 75 percent for 2010. In the case of plan years beginning in 2008, the plan’s funding target attainment percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

Under the provision, the at-risk rules do not apply if a plan had 500 or fewer participants on each day during the preceding plan year. For this purpose, all defined benefit pension plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of such employer’s controlled group, are treated as a single plan, but only participants with respect to such employer or controlled group member are taken into account.

If a plan is in at-risk status, the plan’s funding target and normal cost are determined using the assumptions that: (1) all employees who are not otherwise assumed to retire as of the valuation date, but who will be eligible to elect benefits in the current and 10 succeeding years, are assumed to retire at the earliest retirement date under plan, but not before the end of the plan year; and (2) all employees are assumed to elect the retirement benefit available under the plan at the assumed retirement age that results in the highest present value. In some cases, a loading factor also applies.

The at-risk assumptions are not applied to certain employees of specified automobile manufacturers for purposes of determining whether a plan is in at-risk status, i.e., whether the plan’s funding target attainment percentage, determined using the at-risk assumptions, was less than 70 percent for the preceding plan year. An employee is disregarded for this purpose if: (1) the employee is employed by a specified automobile manufacturer; (2) the employee is offered, pursuant to a bona fide retirement incentive program, a substantial amount of additional cash compensation, substantially enhanced retirement benefits under the plan, or materially reduced employment duties, on the condition that by a specified date no later than December 31, 2010, the employee retires (as defined under the terms of the plan); (3) the offer is made during 2006 pursuant to a bona fide retirement incentive program and requires that the offer can be accepted no later than a specified date (not later than December 31, 2006); and (4) the employee does not accept the offer before the specified date on which the offer expires. For this purpose, a

specified automobile manufacturer is (1) any automobile manufacturer and (2) any manufacturer of automobile parts that supplies parts directly to an automobile manufacturer and which, after a transaction or series of transactions ending in 1999, ceased to be a member of the automobile manufacturer's controlled group.

The funding target of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of all benefits accrued or earned as of the beginning of the plan year, determined using the at-risk assumptions described above, and (2) in the case of a plan that has also been in at-risk status for at least two of the four preceding plans years, a loading factor. The loading factor is the sum of (1) \$700 times the number of participants in the plan, plus (2) four percent of the funding target determined without regard to the loading factor.³² The at-risk funding target is in no event less than the funding target determined without regard to the at-risk rules.

The target normal cost of a plan in at-risk status for a plan year is generally the sum of: (1) the present value of benefits expected to accrue or be earned under the plan during the plan year, determined using the special assumptions described above, and (2) in the case of a plan that has also been in at-risk status for at least two of the four preceding plans years, a loading factor of four percent of the target normal cost determined without regard to the loading factor.³³ The at-risk target normal is in no event less than at-risk normal cost determined without regard to the at-risk rules.

If a plan has been in at-risk status for fewer than five consecutive plan years, the amount of a plan's funding target for a plan year is the sum of: (1) the amount of the funding target determined without regard to the at-risk rules, plus (2) the transition percentage for the plan year of the excess of the amount of the funding target determined under the at-risk rules over the amount determined without regard to the at-risk rules. Similarly, if a plan has been in at-risk status for fewer than five consecutive plan years, the amount of a plan's target normal cost for a plan year is the sum of: (1) the amount of the target normal cost determined without regard to the at-risk rules, plus (2) the transition percentage for the plan year of the excess of the amount of the target normal cost determined under the at-risk rules over the amount determined without regard to the at-risk rules. The transition percentage is the product of 20 percent times the number of consecutive plan years for which the plan has been in at-risk status. In applying this rule, plan years beginning before 2008 are not taken into account.

³² This loading factor is intended to reflect the cost of purchasing group annuity contracts in the case of termination of the plan.

³³ Target normal cost for a plan in at-risk status does not include a loading factor of \$700 per plan participant.

Funding standard carryover balance or prefunding balance

In general

The provision preserves credit balances that have accumulated under present law (referred to as “funding standard carryover balances”). In addition, for plan years beginning after 2007, new credit balances (referred to as “prefunding balances”) result if an employer makes contributions greater than those required under the new funding rules. In general, under the bill, employers may choose whether to count funding standard carryover balances and prefunding balances in determining the value of plan assets or to use the balances to reduce required contributions, but not both. In this regard, the provision provides more favorable rules with respect to the use of funding standard carryover balances.

Under the provision, if the value of a plan’s assets (reduced by any prefunding balance) is at least 80 percent of the plan’s funding target (determined without regard to the at-risk rules) for the preceding plan year,³⁴ the plan sponsor may elect to credit all or a portion of the funding standard carryover balance or prefunding balance against the minimum required contribution for the current plan year (determined after any funding waiver), thus reducing the amount that must be contributed for the current plan year.

The value of plan assets is generally reduced by any funding standard carryover balance or prefunding balance for purposes of determining minimum required contributions, including a plan’s funding shortfall, and a plan’s funding target attainment percentage (discussed above). However, the plan sponsor may elect to permanently reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the minimum required contribution for the plan year. Any reduction of a funding standard carryover balance or prefunding balance applies before determining the balance that is available for crediting against minimum required contributions for the plan year.

Funding standard carryover balance

In the case of a single-employer plan that is in effect for a plan year beginning in 2007 and, as of the end of the 2007 plan year, has a positive balance in the funding standard account maintained under the funding rules as in effect for 2007, the plan sponsor may elect to maintain a funding standard carryover balance. The funding standard carryover balance consists of a beginning balance in the amount of the positive balance in the funding standard account as of the end of the 2007 plan year, decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years (i.e., as of the first day of each plan year beginning after 2008), the funding standard carryover balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the funding standard carryover

³⁴ In the case of plan years beginning in 2008, the percentage for the preceding plan year may be determined using such methods of estimation as the Secretary of Treasury may provide.

balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions).

Prefunding balance

The plan sponsor may elect to maintain a prefunding balance, which consists of a beginning balance of zero for the 2008 plan year, increased and decreased (as described below) and adjusted to reflect the rate of net gain or loss on plan assets.

For subsequent years, i.e., as of the first day of plan year beginning after 2008 (the “current” plan year), the plan sponsor may increase the prefunding balance by an amount, not to exceed (1) the excess (if any) of the aggregate total employer contributions for the preceding plan year, over (2) the minimum required contribution for the preceding plan year. For this purpose, any excess contribution for the preceding plan year is adjusted for interest accruing for the periods between the first day of the current plan year and the dates on which the excess contributions were made, determined using the effective interest rate of the plan for the preceding plan year and treating contributions as being first used to satisfy the minimum required contribution.

The amount by which the aggregate total employer contributions for the preceding plan year exceeds the minimum required contribution for the preceding plan year is reduced (but not below zero) by the amount of contributions an employer would need to make to avoid a benefit limitation that would otherwise be imposed for the preceding plan year under the provisions of the provision relating to benefit limitations for single-employer plans.³⁵ Thus, contributions needed to avoid a benefit limitation do not result in an increase in the plan’s prefunding balance.³⁶

As of the first day of each plan year beginning after 2008, the prefunding balance of a plan is decreased (but not below zero) by the sum of: (1) any amount credited to reduce the minimum required contribution for the preceding plan year, plus (2) any amount elected by the plan sponsor as a reduction in the prefunding balance (thus reducing the amount by which the value of plan assets must be reduced in determining minimum required contributions). As discussed above, if any portion of the prefunding balance is used to reduce a minimum required contribution, the value of plan assets must be reduced by the prefunding balance in determining whether a shortfall amortization base must be established for the plan year (i.e., whether the value of plan assets for a plan year is less than the plan’s funding target for the plan year). Thus, the prefunding balance may not be included in the value of plan assets in order to avoid a shortfall amortization base for a plan year and also used to reduce the minimum required contribution for the same year.

³⁵ Any contribution that may be taken into account in satisfying the requirement to make additional contributions with respect to more than one type of benefit limitation is taken into account only once for purposes of this reduction.

³⁶ The benefit limitations are discussed in Part B below.

Other rules

In determining the prefunding balance or funding standard carryover balance as of the first day of a plan year, the plan sponsor must adjust the balance in accordance with regulations prescribed by the Secretary of the Treasury to reflect the rate of return on plan assets for the preceding year. The rate of return is determined on the basis of the fair market value of the plan assets and must properly take into account, in accordance with regulations, all contributions, distributions, and other plan payments made during the period.

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

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

Other rules and definitions

Valuation date

Under the provision, all determinations made with respect to minimum required contributions for a plan year (such as the value of plan assets and liabilities) must be made as of the plan's valuation date for the plan year. In general, the valuation date for a plan year must be the first day of the plan year. However, any day in the plan year may be designated as the plan's valuation date if, on each day during the preceding plan year, the plan had 100 or fewer participants.³⁷ For this purpose, all defined benefit pension plans (other than multiemployer plans) maintained by the same employer (or a predecessor employer), or by any member of such employer's controlled group, are treated as a single plan, but only participants with respect to such employer or controlled group member are taken into account.

Value of plan assets

Under the provision, the value of plan assets is generally fair market value. However, the value of plan assets may be determined on the basis of the averaging of fair market values, but only if such method: (1) is permitted under regulations; (2) does not provide for averaging of fair market values over more than the period beginning on the last day of the 25th month preceding the month in which the plan's valuation date occurs and ending on the valuation date (or similar period in the case of a valuation date that's not the first day of a month); and (3) does not result in a determination of the value of plan assets that at any time is less than 90 percent or

³⁷ In the case of a plan's first plan year, the ability to use a valuation date other than the first day of the plan year is determined by taking into account the number of participants the plan is reasonably expected to have on each day during that first plan year.

more than 110 percent of the fair market value of the assets at that time. Any averaging must be adjusted for contributions and distributions as provided by the Secretary of the Treasury.

If a required contribution for a preceding plan year is made after the valuation date for the current year, the contribution is taken into account in determining the value of plan assets for the current plan year. For plan years beginning after 2008, only the present value of the contribution is taken into account, determined as of the valuation date for the current plan year, using the plan's effective interest rate for the preceding plan year. In addition, any required contribution for the current plan year is not taken into account in determining the value of plan assets. If any contributions for the current plan year are made before the valuation date, plan assets as of the valuation date does not include (1) the contributions, and (2) interest on the contributions for the period between the date of the contributions and the valuation date, determined using the plan's effective interest rate for the current plan year.

Timing rules for contributions

As under present law, the due date for the payment of a minimum required contribution for a plan year is generally 8½ months after the end of the plan year. Any payment made on a date other than the valuation date for the plan year must be adjusted for interest accruing at the plan's effective interest rate for the plan year for the period between the valuation date and the payment date. Quarterly contributions must be made during a plan year if the plan had a funding shortfall for the preceding plan year (that is, if the value of the plan's assets, reduced by the funding standard carryover balance and prefunding balance, was less than the plan's funding target for the preceding plan year).³⁸ If a quarterly installment is not made, interest applies for the period of underpayment at the rate of interest otherwise applicable (i.e., the plan's effective interest rate) plus 5 percentage points.

Excise tax on failure to make minimum required contributions

The provision retains the present-law rules under which an employer is generally subject to an excise tax if it fails to make minimum required contributions and fails to obtain a waiver from the IRS.³⁹ The excise tax is 10 percent of the aggregate unpaid minimum required contributions for all plan years remaining unpaid as of the end of any plan year. In addition, a tax of 100 percent may be imposed if any unpaid minimum required contributions remain unpaid after a certain period.

³⁸ The provision retains the present-law rules under which the amount of any quarterly installment must be sufficient to cover any liquidity shortfall.

³⁹ The provision retains the present-law rules under which a lien in favor of the plan with respect to property of the employer (and members of the employer's controlled group) arises in certain circumstances in which the employer fails to make required contributions.

Conforming changes

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

Effective Date

The extension of the interest rate applicable in determining current liability for plan years beginning in 2004 and 2005 is effective for plan years beginning after December 31, 2005, and before January 1, 2008. The modifications to the single-employer plan funding rules are effective for plan years beginning after December 31, 2007.

**B. Benefit Limitations Under Single-Employer Defined Benefit Pension Plans
(new secs. 101(j) and 206(g) and (h) of ERISA,
and new secs. 436-437 of the Code)**

Present Law

Plant shutdown and other unpredictable contingent event benefits

A plan may provide for unpredictable contingent event benefits, which are benefits that depend on contingencies other than age, service, compensation, death or disability or that are not reliably and reasonably predictable as determined by the Secretary. Some of these benefits are commonly referred to as “plant shutdown” benefits. Under present law, unpredictable contingent event benefits generally are not taken into account for funding purposes until the event has occurred.

Defined benefit pension plans are not permitted to provide “layoff” benefits (i.e., severance benefits).⁴⁰ However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.⁴¹

Limitation on certain benefit increases while funding waivers in effect

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year.⁴² In the case of a single-employer plan, a waiver may be granted if the employer responsible for the contribution could not make the required contribution without temporary substantial business hardship for the employer (and members of the employer’s controlled group) and if requiring the contribution would be adverse to the interests of plan participants in the aggregate.

If a funding waiver is in effect for a plan, subject to certain exceptions, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.⁴³

Security for certain plan amendments

In the case of a single-employer defined benefit pension plan, if a plan amendment increasing current liability is adopted and the plan’s funded current liability percentage is less than 60 percent (taking into account the effect of the amendment, but disregarding any

⁴⁰ Treas. Reg. sec. 1.401-1(b)(1)(i).

⁴¹ See, e.g., Treas. Reg. secs. 1.401(a)(4)-3(f)(4) and 1.411(a)-7(c).

⁴² Code sec. 412(d); ERISA sec. 303.

⁴³ Code sec. 412(f); ERISA sec. 304(b)(1).

unamortized unfunded old liability), the employer and members of the employer's controlled group must provide security in favor of the plan.⁴⁴ The amount of security required is the excess of: (1) the lesser of (a) the amount by which the plan's assets are less than 60 percent of current liability, taking into account the benefit increase, or (b) the amount of the benefit increase and prior benefit increases after December 22, 1987, over (2) \$10 million. The amendment is not effective until the security is provided.

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

Prohibition on benefit increases during bankruptcy

Subject to certain exceptions, if an employer maintaining a single-employer defined benefit pension plan is involved in bankruptcy proceedings, no plan amendment may be adopted that increases the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits vest under the plan.⁴⁵ This limitation does not apply if the plan's funded current liability percentage is at least 100 percent, taking into account the amendment.

Restrictions on benefit payments due to liquidity shortfalls

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

If a quarterly installment is less than the amount required to cover the plan's liquidity shortfall, limits apply to the benefits that can be paid from a plan during the period of underpayment. During that period, the plan may not make any prohibited payment, defined as: (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period; (2) any payment for the purchase of an irrevocable commitment from an insurer to pay benefits (e.g., an annuity contract); or (3) any other payment specified by the Secretary of the Treasury by regulations.⁴⁶

⁴⁴ Code sec. 401(a)(29); ERISA sec. 307.

⁴⁵ Code sec. 401(a)(33); ERISA sec. 204(i).

⁴⁶ Code sec. 401(a)(32); ERISA sec. 206(e).

Explanation of Provision

Plant shutdown and other unpredictable contingent event benefits

Under the provision, if a participant is entitled to an unpredictable contingent event benefit payable with respect to any event occurring during any plan year, the plan must provide that such benefits may not be provided if the plan's adjusted funding target attainment percentage for that plan year: (1) is less than 60 percent; or (2) would be less than 60 percent taking into account the occurrence of the event. For this purpose, the term unpredictable contingent event benefit means any benefit payable solely by reason of: (1) a plant shutdown (or similar event, as determined by the Secretary of the Treasury); or (2) any event other than attainment of any age, performance of any service, receipt or derivation of any compensation, or the occurrence of death or disability.

The determination of whether the limitation applies is made in the year the unpredictable contingent event occurs. For example, suppose a plan provides for benefits upon the occurrence of a plant shutdown, and a plant shut down occurs in 2010. Taking into account the plan shutdown, the plan's adjusted funding target attainment percentage is less than 60 percent. Thus, the limitation applies, and benefits payable solely by reason of the plant shutdown may not be paid (unless the employer makes contributions to the plan as described below), regardless of whether the benefits will be paid in the 2010 plan year or a later plan year.⁴⁷

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 60 percent, the amount of the increase in the plan's funding target for the plan year attributable to the occurrence of the event; or (2) if the plan's adjusted funding target attainment percentage would be less than 60 percent taking into account the occurrence of the event, the amount sufficient to result in a adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

Plan amendments increasing benefit liabilities

Certain plan amendments may not take effect during a plan year if the plan's adjusted funding target attainment percentage for the plan year: (1) is less than 80 percent; or (2) would be less than 80 percent taking into account the amendment.⁴⁸ In such a case, no amendment may take effect if it has the effect of increasing the liabilities of the plan by reason of any increase in

⁴⁷ Benefits already being paid as a result of a plant shutdown or other event that occurred in a preceding year are not affected by the limitation.

⁴⁸ Under the provision, the present-law rules limiting benefit increases while an employer is in bankruptcy continue to apply.

benefits, the establishment of new benefits, any change in the rate of benefit accrual, or any change in the rate at which benefits vest under the plan. The limitation does not apply to an amendment that provides for an increase in benefits under a formula which is not based on compensation, but only if the rate of increase does not exceed the contemporaneous rate of increase in average wages of the participants covered by the amendment.

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year (or, if later, the effective date of the amendment), if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to: (1) if the plan's adjusted funding target attainment percentage is less than 80 percent, the amount of the increase in the plan's funding target for the plan year attributable to the amendment; or (2) if the plan's adjusted funding target attainment percentage would be less than 80 percent taking into account the amendment, the amount sufficient to result in a adjusted funding target attainment percentage of 80 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

Prohibited payments

A plan must provide that, if the plan's adjusted funding target attainment percentage for a plan year is less than 60 percent, the plan will not make any prohibited payments after the valuation date for the plan year.

A plan must also provide that, if the plan's adjusted funding target attainment percentage for a plan year is 60 percent or greater, but less than 80 percent, the plan may not pay any prohibited payments exceeding the lesser of: (1) 50 percent of the amount otherwise payable under the plan, and (2) the present value of the maximum PBGC guarantee with respect to the participant (determined under guidance prescribed by the PBGC, using the interest rates and mortality table applicable in determining minimum lump-sum benefits). The plan must provide that only one payment under this exception may be made with respect to any participant during any period of consecutive plan years to which the limitation applies. For this purpose, a participant and any beneficiary of the participant (including an alternate payee) is treated as one participant. If the participant's accrued benefit is allocated to an alternate payee and one or more other persons, the amount that may be distributed is allocated in the same manner unless the applicable qualified domestic relations order provides otherwise.

In addition, a plan must provide that, during any period in which the plan sponsor is in bankruptcy proceedings, the plan may not pay any prohibited payment. However, this limitation does not apply on or after the date the plan's enrolled actuary certifies that the adjusted funding target attainment percentage of the plan is not less than 100 percent.

For purposes of these limitations, "prohibited payment" is defined as under the present-law rule restricting distributions during a period of a liquidity shortfall and means (1) any payment in excess of the monthly amount paid under a single life annuity (plus any social security supplement provided under the plan) to a participant or beneficiary whose annuity starting date occurs during the period, (2) any payment for the purchase of an irrevocable

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

The prohibited payment limitation does not apply to a plan for any plan year if the terms of the plan (as in effect for the period beginning on September 1, 2005, and ending with the plan year) provide for no benefit accruals with respect to any participant during the period.

Cessation of benefit accruals

A plan must provide that, if the plan's adjusted funding target attainment percentage is less than 60 percent for a plan year, all future benefit accruals under the plan must cease as of the valuation date for the plan year. The limitation applies only for purposes of the accrual of benefits; service during the freeze period is counted for other purposes. For example, if accruals are frozen under the provision, service earned during the freeze period still counts for vesting purposes. Or, as another example, suppose a plan provides that payment of benefits begins when a participant terminates employment after age 55 and with 25 years of service. Under this example, if a participant who is age 55 and has 23 years of service when the freeze on accruals becomes applicable terminates employment two years later, the participant has 25 years of service for this purpose and thus can begin receiving benefits. However (assuming the freeze on accruals is still in effect), the amount of the benefit is based on the benefit accrued before the freeze (i.e., counting only 23 years of service).

The limitation ceases to apply with respect to any plan year, effective as of the first day of the plan year, if the plan sponsor makes a contribution (in addition to any minimum required contribution for the plan year) equal to the amount sufficient to result in an adjusted funding target attainment percentage of 60 percent.

The limitation does not apply for the first five years a plan (or a predecessor plan) is in effect.

Adjusted funding target attainment percentage

In general

The term "funding target attainment percentage" is defined as under the minimum funding rules, i.e., the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to at-risk status). A plan's adjusted funding target attainment percentage is determined in the same way, except that the value of the plan's assets and the plan's funding target are both increased by the aggregate amount of purchases of annuities for employees other than highly compensated employees made by the plan during the two preceding plan years.

Special rule for fully funded plans

Under a special rule, if a plan's funding target attainment percentage is at least 100 percent, determined by not reducing the value of the plan's assets by any funding standard carryover balance or prefunding balance, the value of the plan's assets is not so reduced in

determining the plan's funding target attainment percentage for purposes of whether the benefit limitations apply. Under a transition rule for a plan year beginning after 2007 and before 2011, the "applicable percentage" for the plan year is substituted for 100 percent in applying the special rule. For this purpose, the applicable percentage is 92 percent for 2007, 94 percent for 2008, 96 percent for 2009, and 98 percent for 2010. However, for any plan year beginning after 2008, the transition rule does not apply unless the plan's funding target attainment percentage (determined by not reducing the value of the plan's assets by any funding standard carryover balance or prefunding balance) for each preceding plan year in the transition period is at least equal to the applicable percentage for the preceding year.

Presumptions as to funded status

Under the provision, certain presumptions apply in determining whether limitations apply with respect to a plan, subject to certification of the plan's adjusted funding target attainment percentage by the plan's enrolled actuary.

If a plan was subject to a limitation for the preceding year, the plan's adjusted funding target attainment percentage for the current year is presumed to be the same as for the preceding year until the plan actuary certifies the plan's actual adjusted funding target attainment percentage for the current year.

If (1) a plan was not subject to a limitation for the preceding year, but its adjusted funding target attainment percentage for the preceding year was not more than 10 percentage points greater than the threshold for a limitation, and (2) as of the first day of the fourth month of the current plan year, the plan actuary has not certified the plan's actual adjusted funding target attainment percentage for the current year, the plan's funding target attainment percentage is presumed to be reduced by 10 percentage points as of that day and that day is deemed to be the plan's valuation date for purposes of applying the benefit limitation. As a result, the limitation applies as of that date until the actuary certifies the plan's actual adjusted funding target attainment percentage.

In any other case, if the plan actuary has not certified the plan's actual adjusted funding target attainment percentage by the first day of the tenth month of the current plan year, for purposes of the limitations, the plan's adjusted funding target attainment percentage is conclusively presumed to be less than 60 percent as of that day and that day is deemed to be the valuation date for purposes of applying the benefit limitations.⁴⁹

⁴⁹ For purposes of applying the presumptions to plan years beginning in 2008, the funding target attainment percentage for the preceding year may be determined using such methods of estimation as the Secretary of Treasury may provide.

Reduction of funding standard carryover and prefunding balances

Election to reduce balances

As discussed above, the value of plan assets is generally reduced by any funding standard carryover or prefunding in determining a plan's funding target attainment percentage. As provided for under the funding rules applicable to single-employer plans, a plan sponsor may elect to reduce a funding standard carryover balance or prefunding balance, so that the value of plan assets is not required to be reduced by that amount in determining the plan's funding target attainment percentage.

Deemed reduction of balances in the case of collectively bargained plans

If a benefit limitation would otherwise apply to a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers, the plan sponsor is treated as having made an election to reduce any prefunding balance or funding standard carryover balance by the amount necessary to prevent the benefit limitation from applying. However, the employer is not treated as having made such an election if the election would not prevent the benefit limitation from applying to the plan.

Deemed reduction of balances in the case of other plans

If the prohibited payment limitation would otherwise apply to a plan that is not maintained pursuant to a collective bargaining agreement, the plan sponsor is treated as having made an election to reduce any prefunding balance or funding standard carryover balance by the amount necessary to prevent the benefit limitation from applying. However, the employer is not treated as having made such an election if the election would not prevent the benefit limitation from applying to the plan.

Contributions made to avoid a benefit limitation

Under the provision, an employer may make contributions (in addition to any minimum required contribution) in an amount sufficient to increase the plan's adjusted funding target attainment percentage to a level to avoid a limitation on unpredictable contingent event benefits, a plan amendment increasing benefits, or additional accruals. An employer may not use a prefunding balance or funding standard carryover balance in lieu of such a contribution, and such a contribution does not result in an increase in any prefunding balance.

Instead of making additional contributions to avoid a benefit limitation, an employer may provide security in the form of a surety bond, cash, certain U.S. government obligations, or such other form as is satisfactory to the Secretary of the Treasury and the parties involved. In such a case, the plan's adjusted funding target attainment percentage is determined by treating the security as a plan asset. Any such security may be perfected and enforced at any time after the earlier of: (1) the date on which the plan terminates; (2) if the plan sponsor fails to make a required contribution for any subsequent plan year, the due date for the contribution; or (3) if the plan's adjusted funding target attainment percentage is less than 60 percent for a consecutive period of seven years, the valuation date for the last year in the period. The security will be released (and any related amounts will be refunded with any accrued interest) at such time as the

Secretary of the Treasury may prescribe in regulations (including partial releases by reason of increases in the plan's funding target attainment percentage).

Treatment of plan as of close of prohibited or cessation period

Under the provision, if a limitation on prohibited payments or future benefit accruals ceases to apply to a plan, all such payments and benefit accruals resume, effective as of the day following the close of the period for which the limitation applies.⁵⁰ Nothing in this rule is to be construed as affecting a plan's treatment of benefits which would have been paid or accrued but for the limitation.

Notice to participants

The plan administrator must provide written notice to participants and beneficiaries within 30 days: (1) after the plan has become subject to the limitation on unpredictable uncontingent event benefits or prohibited payments; (2) in the case of a plan to which the limitation on benefit accruals applies, after the valuation date for the plan year in which the plan's adjusted target attainment percentage is less than 60 percent (or, if earlier, the date the adjusted target attainment percentage is deemed to be less than 60 percent). Notice must also be provided at such other times as may be determined by the Secretary of the Treasury. The notice may be in electronic or other form to the extent such form is reasonably accessible to the recipient.

If the plan administrator fails to provide the required notice, the Secretary of Labor may impose a civil penalty of up to \$1,000 a day from the time of the failure.

Effective Date

The provision generally applies with respect to plan years beginning after December 31, 2007.

In the case of a plan maintained pursuant to one or more collective bargaining agreements between employee representatives and one or more employers ratified before January 1, 2008, the provision does not apply to plan years beginning before the earlier of: (1) the later of (a) the date on which the last collective bargaining agreement relating to the plan terminates (determined without regard to any extension thereof agreed to after the date of enactment), or (b) the first day of the first plan year to which the provision would otherwise apply; or (2) January 1, 2010. For this purpose, any plan amendment made pursuant to a collective bargaining agreement relating to the plan that amends the plan solely to conform to any requirement under the provision is not to be treated as a termination of the collective bargaining agreement.

⁵⁰ This rule does not apply to limitations on unpredictable contingent event benefits and plan amendments increasing liabilities.

C. Special Rules for Multiple-Employer Plans of Certain Cooperatives

Present Law

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

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

A multiple-employer plan is a plan that is maintained by more than one employer and is not maintained pursuant to a collective bargaining agreement.⁵¹ A multiple-employer plan is subject to the minimum funding rules for single-employer plans and to PBGC variable-rate premiums.

Explanation of Provision

The provision provides a delayed effective date for the new single-employer plan funding rules in the case of a plan that was in existence on July 26, 2005, and was an eligible cooperative plan for the plan year including that date. The new funding rules do not apply with respect to such a plan for plan years beginning before the earlier of: (1) the first plan year for which the plan ceases to be an eligible cooperative plan, or (2) January 1, 2017. In addition, in applying the present-law funding rules to an eligible cooperative plan to such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the new funding rules apply, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

A plan is treated as an eligible cooperative plan for a plan year if it is maintained by more than one employer and at least 85 percent of the employers are: (1) certain rural cooperatives;⁵²

⁵¹ A plan maintained by more than one employer pursuant to a collective bargaining agreement is referred to as a multiemployer plan.

⁵² This is as defined in Code section 401(k)(7)(B) without regard to (iv) thereof and includes (1) organizations engaged primarily in providing electric service on a mutual or cooperative basis, or

or (2) certain cooperative organizations that are more than 50-percent owned by agricultural producers or by cooperatives owned by agricultural producers, or organizations that are more than 50-percent owned, or controlled by, one or more such cooperative organizations. A plan is also treated as an eligible cooperative plan for any plan year for which it is maintained by more than one employer and is maintained by a rural telephone cooperative association.

Effective Date

The provision is effective on the date of enactment.

engaged primarily in providing electric service to the public in its service area and which is exempt from tax or which is a State or local government, other than a municipality; (2) certain civic leagues and business leagues exempt from tax 80 percent of the members of which are described in (1); (3) certain cooperative telephone companies; and (4) any organization that is a national association of organizations described above.

D. Temporary Relief for Certain PBGC Settlement Plans

Present Law

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

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

Explanation of Provision

The provision agreement provides a delayed effective date for the new single-employer plan funding rules in the case of a plan that was in existence on July 26, 2005, and was a "PBGC settlement plan" as of that date. The new funding rules do not apply with respect to such a plan for plan years beginning before January 1, 2014. In addition, in applying the present-law funding rules to a such a plan for plan years beginning after December 31, 2007, and before January 1, 2014, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

Under the provision, the term "PBGC settlement plan" means a single-employer defined benefit plan: (1) that was sponsored by an employer in bankruptcy proceedings giving rise to a claim by the PBGC of not greater than \$150 million, and the sponsorship of which was assumed by another employer (not a member of the same controlled group as the bankrupt sponsor) and the PBGC's claim was settled or withdrawn in connection with the assumption of the sponsorship; or (2) that, by agreement with the PBGC, was spun off from a plan subsequently terminated by the PBGC in an involuntary termination.

Effective Date

The provision is effective on the date of enactment.

E. Special Rules for Plans of Certain Government Contractors

Present Law

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

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

Explanation of Provision

The provision provides a delayed effective date for the new single-employer plan funding rules in the case of an eligible government contractor plan. The new funding rules do not apply with respect to such a plan for plan years beginning before the earliest of: (1) the first plan year for which the plan ceases to be an eligible government contractor plan, (2) the effective date of the Cost Accounting Standards Pension Harmonization Rule, and (3) the first plan year beginning after December 31, 2010. In addition, in applying the present-law funding rules to a such a plan for plan years beginning after December 31, 2007, and before the first plan year for which the new funding rules apply, the interest rate used is the interest rate applicable under the new funding rules with respect to payments expected to be made from the plan after the 20-year period beginning on the first day of the plan year (i.e., the third segment rate under the new funding rules).

Under the provision, a plan is treated as an eligible government contractor plan if it is maintained by a corporation (or member of the same affiliated group): (1) whose primary source of revenue is derived from business performed under contracts with the United States that are subject to the Federal Acquisition Regulations and also to the Defense Federal Acquisition Regulation Supplement; (2) whose revenue derived from such business in the previous fiscal year exceeded \$5 billion; and (3) whose pension plan costs that are assignable under those contracts are subject to certain provisions of the Cost Accounting Standards.

The provision also requires the Cost Accounting Standards Board, not later than January 1, 2010, to review and revise the relevant provisions of the Cost Accounting Standards to harmonize minimum contributions required under ERISA of eligible government contractor plans and government reimbursable pension plan costs. Any final rule adopted by the Cost

Accounting Standards Board shall be deemed the Cost Accounting Standards Pension Harmonization Rule.

Effective Date

The provision is effective on the date of enactment.

**F. Modification of Transition Rule to Pension Funding
Requirements for Interstate Bus Company
(769(c) of the Retirement Protection Act, as added by sec. 1508
of the Taxpayer Relief Act of 1997)**

Present Law

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

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

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

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

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

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

Explanation of Provision

The provision revises the special rule for a plan that is sponsored by a company engaged primarily in interurban or interstate passenger bus service and that meets the other requirements for the special rule under present law. The provision extends the application of the special rule under present law for plan years beginning in 2004 and 2005 to plan years beginning in 2006 and 2007. The provision also provides several special rules relating to determining minimum required contributions and variable rate premiums for plan years beginning after 2007 when the new funding rules for single-employer plans apply.

Under the provision, for the plan year beginning in 2006 or 2007, a plan's funded current liability percentage of a plan is treated as at least 90 percent for purposes of determining the amount of required contributions (100 percent for purposes of determining whether quarterly contributions are required). As a result, for the 2006 and 2007 plan years, additional contributions under the deficit reduction contribution rules and quarterly contributions are not required with respect to the plan. In addition, the mortality table used under the plan is used in calculating PBGC variable rate premiums.

Under the provision, for plan years beginning after 2007, the mortality table used under the plan is used in: (1) determining any present value or making any computation under the minimum funding rules applicable to the plan; and (2) calculating PBGC variable rate premiums. Under a special phase-in (in lieu of the phase-in otherwise applicable under the provision relating to funding rules for single-employer plans), for purposes of determining whether a shortfall amortization base is required for plan years beginning after 2007 and before 2012, the applicable percentage of the plan's funding shortfall is the following: 90 percent for 2008, 92 percent for 2009, 94 percent for 2010, and 96 percent for 2011. In addition, for purposes of the quarterly contributions requirement, the plan is treated as not having a funding shortfall for any plan year. As a result, quarterly contributions are not required with respect to the plan.

Effective Date

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

G. Restrictions on Funding of Nonqualified Deferred Compensation Plans by Employers Maintaining Underfunded or Terminated Single-Employer Plans (sec. 409A of the Code)

Present Law

Amounts deferred under a nonqualified deferred compensation plan for all taxable years are currently includible in gross income to the extent not subject to a substantial risk of forfeiture and not previously included in gross income, unless certain requirements are satisfied.⁵³ For example, distributions from a nonqualified deferred compensation plan may be allowed only upon certain times and events. Rules also apply for the timing of elections. If the requirements are not satisfied, in addition to current income inclusion, interest at the underpayment rate plus one percentage point is imposed on the underpayments that would have occurred had the compensation been includible in income when first deferred, or if later, when not subject to a substantial risk of forfeiture. The amount required to be included in income is also subject to a 20-percent additional tax.

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

Explanation of Provision

Under the provision, if during any restricted period in which a defined benefit pension plan of an employer is in at-risk status,⁵⁴ assets are set aside (directly or indirectly) in a trust (or other arrangement as determined by the Secretary of the Treasury), or transferred to such a trust or other arrangement, for purposes of paying deferred compensation of an applicable covered employee, such transferred assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83. The rule does not apply in the case of assets that are set aside before the defined benefit pension plan is in at-risk status.

If a nonqualified deferred compensation plan of an employer provides that assets will be restricted to the provision of benefits under the plan in connection with a restricted period (or

⁵³ Code sec. 409A.

⁵⁴ At-risk status is defined as under the provision relating to funding rules for single-employer defined benefit pension plans and applies if a plan's funding target attainment percentage for the preceding year was less than 60 percent.

other similar financial measure determined by the Secretary of Treasury) of any defined benefit pension plan of the employer, or assets are so restricted, such assets are treated as property transferred in connection with the performance of services (whether or not such assets are available to satisfy the claims of general creditors) under Code section 83.

A restricted period is (1) any period in which a single-employer defined benefit pension plan of an employer is in at risk-status, (2) any period in which the employer is in bankruptcy, and (3) the period that begins six months before and ends six months after the date any defined benefit pension plan of the employer is terminated in an involuntary or distress termination. The provision does not apply with respect to assets set aside before a restricted period.

In general, applicable covered employees include the chief executive officer (or individual acting in such capacity), the four highest compensated officers for the taxable year (other than the chief executive officer), and individuals subject to section 16(a) of the Securities Exchange Act of 1934. An applicable covered employee includes any (1) covered employee of a plan sponsor; (2) covered employee of a member of a controlled group which includes the plan sponsor; and (3) former employee who was a covered employee at the time of termination of employment with the plan sponsor or a member of a controlled group which includes the plan sponsor.

A nonqualified deferred compensation plan is any plan that provides for the deferral of compensation other than a qualified employer plan or any bona fide vacation leave, sick leave, compensatory time, disability pay, or death benefit plan. A qualified employer plan means a qualified retirement plan, tax-deferred annuity, simplified employee pension, and SIMPLE.⁵⁵ A qualified governmental excess benefit arrangement (sec. 415(m)) is a qualified employer plan. An eligible deferred compensation plan (sec. 457(b)) is also a qualified employer plan under the provision. The term plan includes any agreement or arrangement, including an agreement or arrangement that includes one person.

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

Under the provision, if an employer provides directly or indirectly for the payment of any Federal, State or local income taxes with respect to any compensation required to be included in income under the provision, interest is imposed on the amount of such payment in the same manner as if the payment were part of the deferred compensation to which it related. As under present law, such payment is included in income; in addition, under the provision, such payment is subject to a 20 percent additional tax. The payment is also nondeductible by the employer.

⁵⁵ A qualified employer plan also includes a section 501(c)(18) trust.

Effective Date

The provision is effective for transfers or other reservations of assets after date of enactment.

TITLE II: FUNDING RULES FOR MULTIEMPLOYER DEFINED BENEFIT PLANS

A. Funding Rules for Multiemployer Defined Benefit Plans (new sec. 304 of ERISA and new sec. 431 of the Code)

Present Law

Multiemployer plans

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

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

Funding standard account

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

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

Funding methods and general concepts

In general

A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the elements included in its funding standard account for a year. Generally, an actuarial cost method breaks up the cost of benefits under the plan into annual charges consisting

of two elements for each plan year. These elements are referred to as: (1) normal cost; and (2) supplemental cost.

Normal cost

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

Supplemental cost

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

Valuation of assets

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

Reasonableness of assumptions

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

Charges and credits to the funding standard account

In general

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

Normal cost

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

Past service liability

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

Experience gains and losses

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

Gains and losses from changes in assumptions

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

Shortfall funding method

Certain plans may elect to determine the required charges to the funding standard account under the shortfall method. Under such method, the charges are computed on the basis of an estimated number of units of service or production for which a certain amount per unit is to be charged. The difference between the net amount charged under this method and the net amount that otherwise would have been charged for the same period is a shortfall loss or gain that is amortized over subsequent plan years. The use of the shortfall method and changes to use of the shortfall method are generally subject to IRS approval.

Funding waivers and amortization of waived funding deficiencies

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

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

Extension of amortization periods

Amortization periods may be extended for up to 10 years by the Secretary of the Treasury if the Secretary finds that the extension would carry out the purposes of ERISA and would provide adequate protection for participants under the plan and if such Secretary determines that the failure to permit such an extension would (1) result in a substantial risk to the voluntary continuation of the plan or a substantial curtailment of pension benefit levels or employee

compensation, and (2) be adverse to the interests of plan participants in the aggregate. The interest rate with respect to extensions of amortization periods is the same as that used with respect to waived funding deficiencies.

Alternative funding standard account

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

Controlled group liability for required contributions

Unlike the rule for single-employer plans which imposes liability for minimum required contributions to all members of the employer's controlled group, controlled-group liability does not apply to contributions an employer is required to make to a multiemployer plan.

Explanation of Provision

Amortization periods

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

Actuarial assumptions

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

Extension of amortization periods

The provision provides that, upon application to the Secretary of the Treasury, the Secretary is required to grant an extension of the amortization period for up to five years with respect to any unfunded past service liability, investment loss, or experience loss. Included with the application must be a certification by the plan's actuary that (1) absent the extension, the plan

would have an accumulated funding deficiency in the current plan year and any of the nine succeeding plan years, (2) the plan sponsor has adopted a plan to improve the plan's funding status, (3) taking into account the extension, the plan is projected to have sufficient assets to timely pay its expected benefit liabilities and other anticipated expenditures, and (4) that required notice is provided. The automatic extension provision does not apply with respect to any application submitted after December 31, 2014.

The Secretary of the Treasury may also grant an additional extension of such amortization periods for an additional five years. The standards for determining whether such an extension may be granted are the same as under present law. In addition, the provision requires the Secretary of the Treasury to act upon an application for an additional extension within 180 days after submission. If the Secretary rejects the application, the Secretary must provide notice to the plan detailing the specific reasons for the rejection.

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

Interest rate applicable to funding waivers and extension of amortization periods

The provision eliminates the special interest rate rule for funding waivers and extensions of amortization periods so that the plan rate applies.

Additional provisions

Controlled group liability for required contributions

The provision imposes joint and several liability to all members of the employer's controlled group for minimum required contributions to single-employer or multiemployer plans.

Shortfall funding method

The provision provides that, for plan years beginning before January 1, 2015, certain multiemployer plans may adopt, use or cease using the shortfall funding method and such adoption, use, or cessation of use is deemed approved by the Secretary of the Treasury. Plans are eligible if (1) the plan has not used the shortfall funding method during the five-year period ending on the day before the date the plan is to use the shortfall funding method; and (2) the plan is not operating under an amortization period extension and did not operate under such an extension during such five-year period. Benefit restrictions apply during a period that a multiemployer plan is using the shortfall funding method. In general, plan amendments increasing benefits cannot be adopted while the shortfall funding method is in use. The provision is not intended to affect a plan's ability to adopt the shortfall funding method with IRS approval or to affect a plan's right to change funding methods as otherwise permitted.

Effective Date

The provision is effective for plan years beginning after 2007.

**B. Additional Funding Rules for Multiemployer Plans
in Endangered or Critical Status
(new sec. 305 of ERISA and new sec. 432 of the Code)**

Present Law

In general

Multiemployer defined benefit plans are subject to minimum funding rules similar to those applicable to single-employer plans.⁵⁶ If a multiemployer plan has an accumulated funding deficiency for a year, an excise tax of five percent generally applies, increasing to 100 percent if contributions sufficient to eliminate the funding deficiency are not made within a certain period.

Additional required contributions and benefit reductions may apply if a multiemployer plan is in reorganization status or is insolvent.

Reorganization status

Certain modifications to the single-employer plan funding rules apply to multiemployer plans that experience financial difficulties, referred to as “reorganization status.” A plan is in reorganization status for a year if the contribution needed to balance the charges and credits to its funding standard account exceeds its “vested benefits charge.”⁵⁷ The plan’s vested benefits charge is generally the amount needed to amortize, in equal annual installments, unfunded vested benefits under the plan over: (1) 10 years in the case of obligations attributable to participants in pay status; and (2) 25 years in the case of obligations attributable to other participants. A plan in reorganization status is eligible for a special funding credit. In addition, a cap on year-to-year contribution increases and other relief is available to employers that continue to contribute to the plan.

Subject to certain requirements, a multiemployer plan in reorganization status may also be amended to reduce or eliminate accrued benefits in excess of the amount of benefits guaranteed by the PBGC.⁵⁸ In order for accrued benefits to be reduced, at least six months before the beginning of the plan year in which the amendment is adopted, notice must be given that the plan is in reorganization status and that, if contributions to the plan are not increased, accrued benefits will be reduced or an excise tax will be imposed on employers obligated to contribute to the plan. The notice must be provided to plan participants and beneficiaries, any

⁵⁶ See the explanation of the preceding provision for a discussion of the minimum funding rules for multiemployer defined benefit plans. Under Treasury regulations, certain noncollectively bargained employees covered by a multiemployer plan may be treated as collectively bargained employees for purposes of applying the minimum coverage rules of the Code. Treas. Reg. sec. 1.410(b)-6(d)(2)(ii)(D).

⁵⁷ ERISA sec. 4241.

⁵⁸ ERISA sec. 4244A.

employer who has an obligation to contribute to the plan, and any employee organization representing employees in the plan.

Insolvency

In the case of multiemployer plans, the PBGC insures plan insolvency, rather than plan termination. A plan is insolvent when its available resources are not sufficient to pay the plan benefits for the plan year in question, or when the sponsor of a plan in reorganization reasonably determines, taking into account the plan's recent and anticipated financial experience, that the plan's available resources will not be sufficient to pay benefits that come due in the next plan year.⁵⁹ An insolvent plan is required to reduce benefits to the level that can be covered by the plan's assets. However, benefits cannot be reduced below the level guaranteed by the PBGC.⁶⁰ If a multiemployer plan is insolvent, the PBGC guarantee is provided in the form of loans to the plan trustees. If the plan recovers from insolvency status, loans from the PBGC can be repaid. Plans in reorganization status are required to compare assets and liabilities to determine if the plan will become insolvent in the future.

Explanation of Provision

In general

The provision provides additional funding rules for multiemployer defined benefit plans in effect on July 16, 2006, that are in endangered or critical status. The provision requires the adoption of and compliance with (1) a funding improvement plan in the case of a multiemployer plan in endangered status, and (2) a rehabilitation plan in the case of a multiemployer plan in critical status.

Under the provision, in the case of a plan in critical status, additional required contributions and benefit reductions apply and employers are relieved of liability for minimum required contributions under the otherwise applicable funding rules, provided that a rehabilitation plan is adopted and followed.

Annual certification of status; notice; annual reports

Not later than the 90th day of each plan year, the plan actuary must certify to the Secretary of the Treasury and to the plan sponsor whether or not the plan is in endangered or critical status for the plan year. In the case of a plan that is in a funding improvement or rehabilitation period, the actuary must certify whether or not the plan is making scheduled progress in meeting the requirements of its funding improvement or rehabilitation plan.

⁵⁹ ERISA sec. 4245.

⁶⁰ The limit of benefits that the PBGC guarantees under a multiemployer plan is the sum of 100 percent of the first \$11 of monthly benefits and 75 percent of the next \$33 of monthly benefits for each year of service. ERISA sec. 4022A(c).

In making the determinations and projections applicable under the endangered and critical status rules, the plan actuary must make projections for the current and succeeding plan years of the current value of the assets of the plan and the present value of all liabilities to participants and beneficiaries under the plan for the current plan year as of the beginning of such year. The actuary's projections must be based on reasonable actuarial estimates, assumptions, and methods that offer the actuary's best estimate of anticipated experience under the plan. An exception to this rule applies in the case of projected industry activity. Any projection of activity in the industry or industries covered by the plan, including future covered employment and contribution levels, must be based on information provided by the plan sponsor, which shall act reasonably and in good faith. The projected present value of liabilities as of the beginning of the year must be based on the most recent actuarial statement required with respect to the most recently filed annual report or the actuarial valuation for the preceding plan year.

Any actuarial projection of plan assets must assume (1) reasonably anticipated employer contributions for the current and succeeding plan years, assuming that the terms of one or more collective bargaining agreements pursuant to which the plan is maintained for the current plan year continue in effect for the succeeding plan years, or (2) that employer contributions for the most recent plan year will continue indefinitely, but only if the plan actuary determines that there have been no significant demographic changes that would make continued application of such terms unreasonable.

Failure of the plan's actuary to certify the status of the plan is treated as a failure to file the annual report (thus, an ERISA penalty of up to \$1,100 per day applies).

If a plan is certified to be in endangered or critical status, notification of the endangered or critical status must be provided within 30 days after the date of certification to the participants and beneficiaries, the bargaining parties, the PBGC and the Secretary of Labor.⁶¹ If it is certified that a plan is or will be in critical status, the plan sponsor must include in the notice an explanation of the possibility that (1) adjustable benefits may be reduced and (2) such reductions may apply to participants and beneficiaries whose benefit commencement date is on or after the date such notice is provided for the first plan year in which the plan is in critical status. The Secretary of Labor is required to prescribe a model notice to satisfy these requirements.

The plan sponsor must annually update the funding improvement or rehabilitation plan. Updates are required to be filed with the plan's annual report.

Endangered status

Definition of endangered status

A multiemployer plan is in endangered status if the plan is not in critical status and, as of the beginning of the plan year, (1) the plan's funded percentage for the plan year is less than 80

⁶¹ If a plan actuary certifies that it is reasonably expected that a plan will be in critical status with respect to the first plan year after 2007, notice may be provided at any time after date of enactment, as long as it is provided on or before the date otherwise required.

percent, or (2) the plan has an accumulated funding deficiency for the plan year or is projected to have an accumulated funding deficiency in any of the six succeeding plan years (taking into account amortization extensions). A plan's funded percentage is the percentage of plan assets over accrued liability of the plan. A plan that meets the requirements of both (1) and (2) is treated as in seriously endangered status.

Information to be provided to bargaining parties

Within 30 days of the adoption of a funding improvement plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both, which, if adopted, may reasonably be expected to enable the multiemployer plan to meet the applicable benchmarks in accordance with the funding improvement plan, including (1) one proposal for reductions in the amount of future benefit accruals necessary to achieve the applicable benchmarks, assuming no amendments increasing contributions under the plan (other than amendments increasing contributions necessary to achieve the applicable benchmarks after amendments have reduced future benefit accruals to the maximum extent permitted by law) (the "default schedule"), and (2) one proposal for increases in contributions under the plan necessary to achieve the applicable benchmarks, assuming no amendments reducing future benefit accruals under the plan. The applicable benchmarks are the requirements of the funding improvement plan (discussed below). The plan sponsor may provide the bargaining parties with additional information if deemed appropriate.

The plan sponsor must annually update any schedule of contribution rates to reflect the experience of the plan.

Funding improvement plan and funding improvement period

In the case of a multiemployer plan in endangered status, a funding improvement plan must be adopted within 240 days following the deadline for certifying a plan's status.⁶² A funding improvement plan is a plan which consists of the actions, including options or a range of options, to be proposed to the bargaining parties, formulated to provide, based on reasonably anticipated experience and reasonable actuarial assumptions, for the attainment by the plan of certain requirements.

The funding improvement plan must provide that during the funding improvement period, the plan will have a certain required increase in the funded percentage and no accumulated funding deficiency for any plan year during the funding improvement period, taking into account amortization extensions (the "applicable benchmarks"). In the case of a plan that is not in seriously endangered status, under the applicable benchmarks, the plan's funded percentage must increase such that the funded percentage as of the close of the funding improvement period equals or exceeds a percentage equal to the sum of (1) the funded percentage at the beginning of the period, plus (2) 33 percent of the difference between 100 percent and the percentage in (1). Thus, the difference between 100 percent and the plan's

⁶² This requirement applies for the initial determination year (i.e., the first plan year that the plan is in endangered status).

funded percentage at the beginning of the period must be reduced by at least one-third during the funding improvement period.

The funding improvement period is the 10-year period beginning on the first day of the first plan year beginning after the earlier of (1) the second anniversary of the date of adoption of the funding improvement plan, or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of endangered status for the initial determination year and covering, as of such date, at least 75 percent of the plan's active participants. The period ends if the plan is no longer in endangered status or if the plan enters critical status.

In the case of a plan in seriously endangered status that is funded 70 percent or less, under the applicable benchmarks, the difference between 100 percent and the plan's funded percentage at the beginning of the period must be reduced by at least one-fifth during the funding improvement period. In the case of such plans, a 15-year funding improvement period is used.

In the case of a seriously endangered plan that is more than 70 percent funded as of the beginning of the initial determination year, the same benchmarks apply for plan years beginning on or before the date on which the last collective bargaining agreements in effect on the date for actuarial certification for the initial determination year and covering at least 75 percent of active employees in the multiemployer plan have expired if the plan actuary certifies within 30 days after certification of endangered status that the plan is not projected to attain the funding percentage increase otherwise required by the provision. Thus, for such plans, the difference between 100 percent and the plan's funded percentage at the beginning of the period must be reduced by at least one-fifth during the 15-year funding improvement period. For subsequent years for such plans, if the plan actuary certifies that the plan is not able to attain the increase generally required under the provision, the same benchmarks continue to apply.

As previously discussed, the plan sponsor must annually update the funding improvement plan and must file the update with the plan's annual report.

If, for the first plan year following the close of the funding improvement period, the plan's actuary certifies that the plan is in endangered status, such year is treated as an initial determination year. Thus, a new funding improvement plan must be adopted within 240 days of the required certification date. In such case, the plan may not be amended in a manner inconsistent with the funding improvement plan in effect for the preceding plan year until a new funding improvement plan is adopted.

Requirements pending approval of plan and during funding improvement period

Certain restrictions apply during the period beginning on the date of certification for the initial determination year and ending on the day before the first day of the funding improvement period (the "funding plan adoption period").

During the funding plan adoption period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of

service; or (3) any new or indirect exclusion of younger or newly hired employees from plan participation.

In addition, during the funding plan adoption period, except in the case of amendments required as a condition of qualification under the Internal Revenue Code or to apply with other applicable law, no amendment may be adopted which increases liabilities of the plan by reason of any increase in benefits, any change in accrual of benefits, or any change in the rate at which benefits become nonforfeitable under the plan.

In the case of a plan in seriously endangered status, during the funding plan adoption period, the plan sponsor must take all reasonable actions (consistent with the terms of the plan and present law) which are expected, based on reasonable assumptions, to achieve an increase in the plan's funded percentage and a postponement of an accumulated funding deficiency for at least one additional plan year. These actions include applications for extensions of amortization periods, use of the shortfall funding method in making funding standard account computations, amendments to the plan's benefit structure, reductions in future benefit accruals, and other reasonable actions.

Upon adoption of a funding improvement plan, the plan may not be amended to be inconsistent with the funding improvement plan. During the funding improvement period, a plan sponsor may not accept a collective bargaining agreement or participation agreement with respect to the multiemployer plan that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of service, or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation.

After the adoption of a funding improvement plan, a plan may not be amended to increase benefits, including future benefit accruals, unless the plan actuary certifies that the benefit increase is consistent with the funding improvement plan and is paid for out of contributions not required by the funding improvement plan to meet the applicable benchmark in accordance with the schedule contemplated in the funding improvement plan.

Effect of and penalty for failure to adopt a funding improvement plan

If a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and after receiving one or more schedules from the plan sponsor, the bargaining parties fail to agree on changes to contribution or benefit schedules necessary to meet the applicable benchmarks, the plan sponsor must implement the default schedule. The schedule must be implemented on the earlier of the date (1) on which the Secretary of Labor certifies that the parties are at an impasse, or (2) which is 180 days after the date on which the collective bargaining agreement expires.

In the case of the failure of a plan sponsor to adopt a funding improvement plan by the end of the 240-day period after the required certification date, an ERISA penalty of up to \$1,100 a day applies.

Excise tax on employers failing to meet required contributions

If the funding improvement plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

Application of excise tax to plans in endangered status/penalty for failure to achieve benchmarks

In the case of a plan in endangered status, which is not in seriously endangered status, a civil penalty of \$1,100 a day applies for the failure of the plan to meet the applicable benchmarks by the end of the funding improvement period.

In the case of a plan in seriously endangered status, an excise tax applies for the failure to meet the benchmarks by the end of the funding improvement period. In such case, an excise tax applies based on the greater of (1) the amount of the contributions necessary to meet such benchmarks or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the benchmarks are met.

Waiver of excise tax

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to achieve the applicable benchmarks. The party against whom the tax is imposed has the burden of establishing that the failure was due to reasonable cause and not willful neglect. Reasonable cause includes unanticipated and material market fluctuations, the loss of a significant contributing employer, or other factors to the extent that the payment of tax would be excessive or otherwise inequitable relative to the failure involved. The determination of reasonable cause is based on the facts and circumstances of each case and requires the parties to act with ordinary business care and prudence. The standard requires the funding improvement plan to be based on reasonably foreseeable events. It is expected that reasonable cause would include instances in which the plan experiences a net equity loss of at least ten percent during the funding improvement period, a change in plan demographics such as the bankruptcy of a significant contributing employer, a legal change (including the outcome of litigation) that unexpectedly increases the plan's benefit obligations, or a strike or lockout for a significant period.

Critical status

Definition of critical status

A multiemployer plan is in critical status for a plan year if as of the beginning of the plan year:

1. The funded percentage of the plan is less than 65 percent and the sum of (A) the market value of plan assets, plus (B) the present value of reasonably anticipated employer and employee contributions for the current plan year and each of the six

succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the six succeeding plan years (plus administrative expenses),

2. (A) The plan has an accumulated funding deficiency for the current plan year, not taking into account any amortization extension, or (B) the plan is projected to have an accumulated funding deficiency for any of the three succeeding plan years (four succeeding plan years if the funded percentage of the plan is 65 percent or less), not taking into account any amortization extension,
3. (A) The plan's normal cost for the current plan year, plus interest for the current plan year on the amount of unfunded benefit liabilities under the plan as of the last day of the preceding year, exceeds the present value of the reasonably anticipated employer contributions for the current plan year, (B) the present value of nonforfeitable benefits of inactive participants is greater than the present value of nonforfeitable benefits of active participants, and (C) the plan has an accumulated funding deficiency for the current plan year, or is projected to have an accumulated funding deficiency for any of the four succeeding plan years (not taking into account amortization period extensions), or
4. The sum of (A) the market value of plan assets, plus (B) the present value of the reasonably anticipated employer contributions for the current plan year and each of the four succeeding plan years (assuming that the terms of the collective bargaining agreements continue in effect) is less than the present value of all benefits projected to be payable under the plan during the current plan year and each of the four succeeding plan years (plus administrative expenses).

Additional contributions during critical status

In the case of a plan in critical status, the provision imposes an additional required contribution ("surcharge") on employers otherwise obligated to make a contribution in the initial critical year, i.e., the first plan year for which the plan is in critical status. The amount of the surcharge is five percent of the contribution otherwise required to be made under the applicable collective bargaining agreement. The surcharge is 10 percent of contributions otherwise required in the case of succeeding plan years in which the plan is in critical status. The surcharge applies 30 days after the employer is notified by the plan sponsor that the plan is in critical status and the surcharge is in effect. The surcharges are due and payable on the same schedule as the contributions on which the surcharges are based. Failure to make the surcharge payment is treated as a delinquent contribution. The surcharge is not required with respect to employees covered by a collective bargaining agreement (or other agreement pursuant to which the employer contributes), beginning on the effective date of a collective bargaining agreement (or other agreement) that includes terms consistent with a schedule presented by the plan sponsor. The amount of the surcharge may not be the basis for any benefit accrual under the plan.

Surcharges are disregarded in determining an employer's withdrawal liability except for purposes of determining the unfunded vested benefits attributable to an employer under ERISA section 4211(c)(4) or a comparable method approved under ERISA section 4211(c)(5).⁶³

Reductions to previously earned benefits

Notwithstanding the anti-cutback rules, the plan sponsor may make any reductions to adjustable benefits which the plan sponsor deems appropriate, based upon the outcome of collective bargaining over the schedules required to be provided by the plan sponsor as discussed below. Adjustable benefits means (1) benefits, rights, and features under the plan, including post-retirement death benefits, 60-month guarantees, disability benefits not yet in pay status, and similar benefits; (2) any early retirement benefit or retirement-type subsidy and any benefit payment option (other than the qualified joint-and-survivor annuity); and (3) benefit increase that would not be eligible for PBGC guarantee on the first day of the initial critical year because the increases were adopted (or, if later, took effect) less than 60 months before such first day. Except as provided in (3), nothing should be construed to permit a plan to reduce the level of a participant's accrued benefit payable at normal retirement age.

The plan sponsor may not reduce adjustable benefits of any participant or beneficiary whose benefit commencement date is before the date on which the plan provides notice to the participant or beneficiary that the plan is in critical status and that benefits may be reduced. An exception applies in the case of benefit increases that would not be eligible for PBGC guarantee because the increases were adopted less than 60 months before the first day of the initial critical year.

The plan sponsor must include in the schedules provided to the bargaining parties an allowance for funding the benefits of participants with respect to whom contributions are not currently required to be made, and shall reduce their benefits to the extent permitted under the Code and ERISA and considered appropriate by the plan sponsor based on the plan's then current overall funding status.

Notice of any reduction of adjustable benefits must be provided at least 30 days before the general effective date of the reduction for all participants and beneficiaries. Benefits may not be reduced until the notice requirement is satisfied. Notice must be provided to (1) plan participants and beneficiaries; (2) each employer who has an obligation to contribute under the plans; and (3) each employee organization which, for purposes of collective bargaining, represents plan participants employed by such employer. The notice must contain (1) sufficient information to enable participants and beneficiaries to understand the effect of any reduction of their benefits, including an estimate (on an annual or monthly basis) of any affected adjustable benefit that a participant or beneficiary would otherwise have been eligible for as of the general effective date for benefit reductions; and (2) information as to the rights and remedies of plan participants and beneficiaries as well as how to contact the Department of Labor for further

⁶³ The PBGC is directed to prescribe simplified methods for determining withdrawal liability in this case.

information and assistance where appropriate. The notice must be provided in a form and manner prescribed in regulations of the Secretary of Labor. In such regulations, the Secretary of Labor must establish a model notice.

Benefit reductions are disregarded in determining a plan's unfunded vested benefits for purposes of determining an employer's withdrawal liability.⁶⁴

Information to be provided to bargaining parties

Within 30 days after adoption of the rehabilitation plan, the plan sponsor must provide to the bargaining parties schedules showing revised benefit structures, revised contribution structures, or both which, if adopted, may reasonably be expected to enable the multiemployer plan to emerge from critical status in accordance with the rehabilitation plan.⁶⁵ The schedules must reflect reductions in future benefit accruals and adjustable benefits and increases in contributions that the plan sponsor determined are reasonably necessary to emerge from critical status. One schedule must be designated as the default schedule and must assume no increases in contributions other than increases necessary to emerge from critical status after future benefit accruals and other benefits (other than benefits the reduction or elimination of which are not permitted under the anti-cutback rules) have been reduced. The plan sponsor may also provide additional information as appropriate.

The plan sponsor must periodically update any schedule of contribution rates to reflect the experience of the plan.

Rehabilitation plan

If a plan is in critical status for a plan year, the plan sponsor must adopt a rehabilitation plan within 240 days following the required date for the actuarial certification of critical status.⁶⁶

A rehabilitation plan is a plan which consists of actions, including options or a range of options to be proposed to the bargaining parties, formulated, based on reasonable anticipated experience and reasonable actuarial assumptions, to enable the plan to cease to be in critical status by the end of the rehabilitation period and may include reductions in plan expenditures (including plan mergers and consolidations), reductions in future benefits accruals or increases in contributions, if agreed to by the bargaining parties, or any combination of such actions.

⁶⁴ The PBGC is directed to prescribe simplified methods for determining withdrawal liability in this case.

⁶⁵ A schedule of contribution rates provided by the plan sponsor and relied upon by bargaining parties in negotiating a collective bargaining agreement must remain in effect for the duration of the collective bargaining agreement.

⁶⁶ The requirement applies with respect to the initial critical year.

A rehabilitation plan must provide annual standards for meeting the requirements of the rehabilitation. The plan must also include the schedules required to be provided to the bargaining parties.

If the plan sponsor determines that, based on reasonable actuarial assumptions and upon exhaustion of all reasonable measures, the plan cannot reasonably be expected to emerge from critical status by the end of the rehabilitation period, the plan must include reasonable measures to emerge from critical status at a later time or to forestall possible insolvency. In such case, the plan must set forth alternatives considered, explain why the plan is not reasonable expected to emerge from critical status by the end of the rehabilitation period, and specify when, if ever, the plan is expected to emerge from critical status in accordance with the rehabilitation plan.

As previously discussed, the plan sponsor must annually update the rehabilitation plan and must file the update with the plan's annual report.

Rehabilitation period

The rehabilitation period is the 10-year period beginning on the first day of the first plan year following the earlier of (1) the second anniversary of the date of adoption of the rehabilitation plan or (2) the expiration of collective bargaining agreements that were in effect on the due date for the actuarial certification of critical status for the initial critical year and covering at least 75 percent of the active participants in the plan.

The rehabilitation period ends if the plan emerges from critical status. A plan in critical status remains in critical status until a plan year for which the plan actuary certifies that the plan is not projected to have an accumulated funding deficiency for the plan year or any of the nine succeeding plan years, without regard to the use of the shortfall method and taking into account amortization period extensions.

Rules for reductions in future benefit accrual rates

Any schedule including reductions in future benefit accruals forming part of a rehabilitation plan must not reduce the rate of benefit accruals below (1) a monthly benefit (payable as a single life annuity commencing at the participant's normal retirement age) equal to one percent of the contributions required to be made with respect to a participant or the equivalent standard accrual rate for a participant or group of participants under the collective bargaining agreements in effect as of the first day of the initial critical year, or (2) if lower, the accrual rate under the plan on such first day.

The equivalent standard accrual rate is determined by the plan sponsor based on the standard or average contribution base units which the plan sponsor determines to be representative for active participants and such other factors that the plan sponsor determines to be relevant.

Benefit reductions are disregarded in determining an employer's withdrawal liability.

Requirements pending approval and during rehabilitation period

Rehabilitation plan adoption period.—Certain restrictions apply during the period beginning on the date of certification and ending on the day before the first day of the rehabilitation period (defined as the “rehabilitation plan adoption period”).

During the rehabilitation plan adoption period, the plan sponsor may not accept a collective bargaining agreement or participation agreement that provides for (1) a reduction in the level of contributions for any participants; (2) a suspension of contributions with respect to any period of service; or (3) any new direct or indirect exclusion of younger or newly hired employees from plan participation. Except in the case of amendments required as a condition of qualification under the Internal Revenue Code or to comply with other applicable law, during the rehabilitation plan adoption period, no amendments that increase the liabilities of the plan by reason of any increase in benefits, any change in the accrual of benefits, or any change in the rate at which benefits become nonforfeitable may be adopted.

During rehabilitation period.—A plan may not be amended after the date of adoption of a rehabilitation plan to be inconsistent with the rehabilitation plan.

A plan may not be amended after the date of adoption of a rehabilitation plan to increase benefits (including future benefit accruals) unless the plan actuary certifies that such increase is paid for out of additional contributions not contemplated by the rehabilitation plan and, after taking into account the benefit increases, the plan is still reasonably expected to emerge from critical status by the end of the rehabilitation period on the schedule contemplated by the rehabilitation plan.

Beginning on the date that notice of certification of the plan’s critical status is sent, lump sum and other similar benefits may not be paid. The restriction does not apply if the present value of the participant’s accrued benefit does not exceed \$5,000. The restriction also does not apply to any makeup payment in the case of a retroactive annuity starting date or any similar payment of benefits owed with respect to a prior period.

The plan sponsor must annually update the plan and must file updates with the plan’s annual report. Schedules must be annually updated to reflect experience of the plan.

Effect and penalty for failure to adopt a rehabilitation plan

If a collective bargaining agreement providing for contributions under a multiemployer plan that was in effect at the time the plan entered endangered status expires, and after receiving one of more schedules from the plan sponsor, the bargaining parties fail to adopt a contribution or benefit schedule with terms consistent with the rehabilitation plan and the scheduled from the plan sponsor, the plan sponsor must implement the default schedule. The schedule must be implemented on the earlier of the date (1) on which the Secretary of Labor certifies that the parties are at an impasse, or (2) which is 180 days after the date on which the collective bargaining agreement expires.

Upon the failure of a plan sponsor to adopt a rehabilitation plan within 240 days after the date required for certification, an ERISA penalty of \$1,100 a day applies. In addition, upon the

failure to timely adopt a rehabilitation plan, an excise tax is imposed on the plan sponsor equal to the greater of (1) the present law excise tax or (2) \$1,100 per day. The tax must be paid by the plan sponsor.

Excise tax on employers failing to meet required contributions

If the rehabilitation plan requires an employer to make contributions to the plan, an excise tax applies upon the failure of the employer to make such required contributions within the time required under the plan. The amount of tax is equal to the amount of the required contribution the employer failed to make in a timely manner.

Application of excise tax to plans in critical status/penalty for failure to meet benchmarks or make scheduled progress

In the case of a plan in critical status, if a rehabilitation plan is adopted and complied with, employers are not liable for contributions otherwise required under the general funding rules. In addition, the present-law excise tax does not apply.

If a plan fails to leave critical status at the end of the rehabilitation period or fails to make scheduled progress in meeting its requirements under the rehabilitation plan for three consecutive years, the present law excise tax applies based on the greater of (1) the amount of the contributions necessary to leave critical status or make scheduled progress or (2) the plan's accumulated funding deficiency. The excise tax applies for each succeeding plan year until the requirements are met.

Waiver of excise tax

In the case of a failure which is due to reasonable cause and not to willful neglect, the Secretary of the Treasury may waive all or part of the excise tax on employers failing to make required contributions and the excise tax for failure to meet the rehabilitation plan requirements or make scheduled progress. The standards applicable to waivers of the excise tax for plans in endangered status apply to waivers of plans in critical status.

Additional rules

In general

The actuary's determination with respect to a plan's normal cost, actuarial accrued liability, and improvements in a plan's funded percentage must be based on the unit credit funding method (whether or not that method is used for the plan's actuarial valuation).

In the case of a plan sponsor described under section 404(c) of the Code, the term "plan sponsor" means the bargaining parties.

Expedited resolution of plan sponsor decisions

If, within 60 days of the due date for the adoption of a funding improvement plan or a rehabilitation plan, the plan sponsor has not agreed on a funding improvement plan or a

rehabilitation plan, any member of the board or group that constitutes the plan sponsor may require that the plan sponsor enter into an expedited dispute resolution procedure for the development and adoption of a funding improvement plan or rehabilitation plan.

Nonbargained participation

In the case of an employer who contributes to a multiemployer plan with respect to both employees who are covered by one or more collective bargaining agreements and to employees who are not so covered, if the plan is in endangered or critical status, benefits of and contributions for the nonbargained employees, including surcharges on those contributions, must be determined as if the nonbargained employees were covered under the first to expire of the employer's collective bargaining agreements in effect when the plan entered endangered or critical status.⁶⁷ In the case of an employer who contributes to a multiemployer plan only with respect to employees who are not covered by a collective bargaining agreement, the additional funding rules apply as if the employer were the bargaining party, and its participation agreement with the plan was a collective bargaining agreement with a term ending on the first day of the plan year beginning after the employer is provided the schedule requires to be provided by the plan sponsor.

Special rule for certain restored benefits

In the case of benefits which were reduced pursuant to a plan amendment adopted on or after January 1, 2002, and before June 30, 2005, if, pursuant to the plan document, the trust agreement, or a formal written communication from the plan sponsor to participants provided before June 30, 2005, such benefits were restored, the rules under the provision do not apply to such benefit restorations to the extent that any restriction on the providing or accrual of such benefits would otherwise apply by reason of the provision.

Cause of action to compel adoption of funding improvement or rehabilitation plan

The provision creates a cause of action under ERISA in the case that the plan sponsor of a plan certified to be endangered or critical (1) has not adopted a funding improvement or rehabilitation plan within 240 days of certification of endangered or critical or (2) fails to update or comply with the terms of the funding improvement or rehabilitation plan. In such case, a civil action may be brought by an employer that has an obligation to contribute with respect to the plan, or an employee organization that represents active participants, for an order compelling the plan sponsor to adopt a funding improvement or rehabilitation plan or to update or comply with the terms of the funding improvement or rehabilitation plan.

⁶⁷ Treasury regulations allowing certain noncollectively bargained employees covered by a multiemployer plan to be treated as collectively bargained employees for purposes of the minimum coverage rules of the Code do not apply in making determinations under the provision.

Effective Date

The provision is effective for plan years beginning after 2007. The additional funding rules for plans in endangered or critical status do not apply to plan years beginning after December 31, 2014.

If a plan is operating under a funding improvement or rehabilitation plan for its last year beginning before January 1, 2015, the plan shall continue to operate under such funding improvement or rehabilitation plan during any period after December 31, 2014, that such funding improvement or rehabilitation plan is in effect.

**C. Measures to Forestall Insolvency of Multiemployer Plans
(sec. 4245 of ERISA and sec. 418E of the Code)**

Present Law

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

In order to anticipate future insolvencies, at the end of the first plan year in which a plan is in reorganization and at least every three plans year thereafter, the plan sponsor must compare the value of plan assets for the plan year with the total amount of benefit payments made under the plan for the plan year.⁶⁸ Unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next three plan years.

Explanation of Provision

The provision modifies the requirements for anticipating future insolvencies of plans in reorganization status. Under the provision, unless the plan sponsor determines that the value of plan assets exceeds three times the total amount of benefit payments, the plan sponsor must determine whether the plan will be insolvent for any of the next five plan years, rather than three plan years as under present law. If the plan sponsor makes a determination that the plan will be insolvent for any of the next five plan years, the plan sponsor must make the comparison of plan assets and benefit payments under the plan at least annually until the plan sponsor makes a determination that the plan will not be insolvent in any of the next five plan years.

Effective Date

The provision is effective with respect to determinations made in plan years beginning after 2007.

⁶⁸ Code sec. 418E(d)(1); ERISA sec. 4245(d)(1).

D. Withdrawal Liability Reforms
(secs. 4203, 4205, 4210, 4219, 4221 and 4225 of ERISA)

1. Repeal of limitation on withdrawal liability in certain cases

Present Law

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.⁶⁹ In general, a "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.⁷⁰ A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.⁷¹

When an employer withdraws from a multiemployer plan, the plan sponsor is required to determine the amount of the employer's withdrawal liability, notify the employer of the amount of the withdrawal liability, and collect the amount of the withdrawal liability from the employer.⁷² The employer's withdrawal liability generally is based on the extent of the plan's unfunded vested benefits for the plan years preceding the withdrawal.⁷³

ERISA section 4225 provides rules limiting or subordinating withdrawal liability in certain cases. The amount of unfunded vested benefits allocable to an employer is limited in the case of certain sales of all or substantially all of the employer's assets and in the case of an insolvent employer undergoing liquidation or dissolution.

In the case of a bona fide sale of all or substantially all of the employer's assets in an arm's length transaction to an unrelated party, the unfunded vested benefits allocable to an employer is limited to the greater of (1) a portion of the liquidation or dissolution value of the employer (determined after the sale or exchange of such assets), or (2) the unfunded vested benefits attributable to the employees of the employer. The portion to be used in (1) is determined in accordance with a table described in ERISA section 4225(a)(2). Other limitations on withdrawal liability also apply.

⁶⁹ ERISA sec. 4201.

⁷⁰ ERISA sec. 4203.

⁷¹ ERISA sec. 4205.

⁷² ERISA sec. 4202.

⁷³ ERISA secs. 4209 and 4211.

Explanation of Provision

The provision prescribes a new table under ERISA section 4225(a)(2) to be used in determining the portion of the liquidation or dissolution value of the employer for the calculation of the limitation of unfunded vested benefits allocable to an employer in the case of a bona fide sale of all or substantially all of the employer's assets in an arm's length transaction to an unrelated party. The provision also modifies the calculation of the limit so that the unfunded vested benefits allocable to an employer do not exceed the greater of (1) a portion of the liquidation or dissolution value of the employer (determined after the sale or exchange of such assets), or (2) in the case of a plan using the attributable method of allocating withdrawal liability, the unfunded vested benefits attributable to the employees of the employer. Present law ERISA section 4225(b) is not amended by the provision.

Effective Date

The provisions are effective for sales occurring on or after January 1, 2007.

2. Withdrawal liability continues if work contracted out

Present Law

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.⁷⁴ In general, a "complete withdrawal" means the employer has permanently ceased operations under the plan or has permanently ceased to have an obligation to contribute.⁷⁵

A "partial withdrawal" generally occurs if, on the last day of a plan year, there is a 70-percent contribution decline for such plan year or there is a partial cessation of the employer's contribution obligation.⁷⁶ A partial cessation of the employer's obligation occurs if (1) the employer permanently ceases to have an obligation to contribute under one or more, but fewer than all collective bargaining agreements under which obligated to contribute, but the employer continues to perform work in the jurisdiction of the collective bargaining agreement or transfers such work to another location or (2) an employer permanently ceases to have an obligation to contribute under the plan with respect to work performed at one or more, but fewer than all of its facilities, but continues to perform work at the facility of the type for which the obligation to contribute ceased.⁷⁷

⁷⁴ ERISA sec. 4201.

⁷⁵ ERISA sec. 4203.

⁷⁶ ERISA sec. 4205.

⁷⁷ ERISA sec. 4205(b)(2).

Explanation of Provision

Under the provision, a partial withdrawal also occurs if the employer permanently ceases to have an obligation to contribute under one or more, but fewer than all collective bargaining agreements under which obligated to contribute, but the employer transfers such work to an entity or entities owned or controlled by the employer.

Effective Date

The provision is effective with respect to work transferred on or after the date of enactment.

3. Application of forgiveness rule to plans primarily covering employees in building and construction

Present Law

Under ERISA, an employer which withdraws from a multiemployer plan in a complete or partial withdrawal is liable to the plan in the amount determined to be the employer's withdrawal liability.⁷⁸ A multiemployer plan, other than a plan which primarily covers employees in the building and construction industry, may adopt a rule that an employer who withdraws from the plan is not subject to withdrawal liability if certain requirements are satisfied.⁷⁹ In general, the employer is not liable if the employer (1) first had an obligation to contribute to the plan after the date of enactment of the Multiemployer Pension Plan Amendments Act of 1980; (2) contributed to the plan for no more than the lesser of six plan years or the number of years required for vesting under the plan; (3) was required to make contributions to the plan for each year in an amount equal to less than two percent of all employer contributions for the year; and (4) never avoided withdrawal liability because of the special rule.

A multiemployer plan, other than a plan that primarily covers employees in the building and construction industry, may be amended to provide that the amount of unfunded benefits allocable to an employer that withdraws from the plan is determined under an alternative method.⁸⁰

Explanation of Provision

The provision extends the rule allowing plans to exempt certain employers from withdrawal liability to plans primarily covering employees in the building and construction industries. In addition, the provision also provides that a plan (including a plan which primarily covers employees in the building and construction industry) may be amended to provide that the

⁷⁸ ERISA sec. 4201.

⁷⁹ ERISA sec. 4210.

⁸⁰ ERISA sec. 4211(c)(1).

withdrawal liability method otherwise applicable shall be applied by substituting the plan year which is specified in the amendment and for which the plan has no unfunded vested benefits for the plan year ending before September 26, 1980.

Effective Date

The provision is effective with respect to plan withdrawals occurring on or after January 1, 2007.

4. Procedures applicable to disputes involving withdrawal liability

Present Law

Under ERISA, when an employer withdraws from a multiemployer plan, the employer is generally liable for its share of unfunded vested benefits, determined as of the date of withdrawal (generally referred to as the “withdrawal liability”). Whether and when a withdrawal has occurred and the amount of the withdrawal liability is determined by the plan sponsor. The plan sponsor’s assessment of withdrawal liability is presumed correct unless the employer shows by a preponderance of the evidence that the plan sponsor’s determination of withdrawal liability was unreasonable or clearly erroneous. A similar standard applies in the event the amount of the plan’s unfunded vested benefits is challenged.

The first payment of withdrawal liability determined by the plan sponsor is generally due no later than 60 days after demand, even if the employer contests the determination of liability. Disputes between an employer and plan sponsor concerning withdrawal liability are resolved through arbitration, which can be initiated by either party. Even if the employer contests the determination, payments of withdrawal liability must be made by the employer until the arbitrator issues a final decision with respect to the determination submitted for arbitration.

For purposes of withdrawal liability, all trades or businesses under common control are treated as a single employer. In addition, the plan sponsor may disregard a transaction in order to assess withdrawal liability if the sponsor determines that the principal purpose of the transaction was to avoid or evade withdrawal liability. For example, if a subsidiary of a parent company is sold and the subsidiary then withdraws from a multiemployer plan, the plan sponsor may assess withdrawal liability as if the subsidiary were still part of the parent company’s controlled group if the sponsor determines that a principal purpose of the sale of the subsidiary was to evade or avoid withdrawal liability.

In the case of an employer that receives a notification of withdrawal liability and demand for payment after October 31, 2003, a special rule may apply if a transaction is disregarded by a plan sponsor in determining that a withdrawal has occurred or that an employer is liable for withdrawal liability. If the transaction that is disregarded by the plan sponsor occurred before January 1, 1999, and at least five years before the date of the withdrawal, then (1) the determination by the plan sponsor that a principal purpose of the transaction was to evade or avoid withdrawal liability is not be presumed to be correct, (2) the plan sponsor, rather than the employer, has the burden to establish, by a preponderance of the evidence, the elements of the claim that a principal purpose of the transaction was to evade or avoid withdrawal liability, and (3) if an employer contests the plan sponsor’s determination through an arbitration proceeding,

or through a claim brought in a court of competent jurisdiction, the employer is not obligated to make any withdrawal liability payments until a final decision in the arbitration proceeding, or in court, upholds the plan sponsor's determination.

Explanation of Provision

Under the provision, if (1) a plan sponsor determines that a complete or partial withdrawal of an employer has occurred or an employer is liable for withdrawal liability payments with respect to the complete or partial withdrawal from the plan and (2) such determination is based in whole or in part on a finding by the plan sponsor that a principal purpose of any transaction that occurred after December 31, 1998, and at least five years (two years in the case of a small employer) before the date of complete or partial withdrawal was to evade or avoid withdrawal liability, the person against which the withdrawal liability is assessed may elect to use a special rule relating to required payments. Under the special rule, if the electing person contests the plan sponsor's determination with respect to withdrawal liability payments through an arbitration proceeding, through a claim brought in a court of competent jurisdiction, or as otherwise permitted by law, the electing person is not obligated to make the withdrawal liability payments until a final decision in the arbitration proceeding, or in court, upholds the plan sponsor's determination. The special rule applies only if the electing person (1) provides notice to the plan sponsor of its election to apply the special rule within 90 days after the plan sponsor notifies the electing person of its liability, and (2) if a final decision on the arbitration proceeding, or in court, of the withdrawal liability dispute has not been rendered within 12 months from the date of such notice, the electing person provides to the plan, effective as of the first day following the 12-month period, a bond issued by a corporate surety, or an amount held on escrow by a bank or similar financial institution satisfactory to the plan, in an amount equal to the sum of the withdrawal liability payments that would otherwise be due for the 12-month period beginning with the first anniversary of such notice. The bond or escrow must remain in effect until there is a final decision in the arbitration proceeding, or on court, of the withdrawal liability dispute. At such time, the bond or escrow must be paid to the plan if the final decision upholds the plan sponsor's determination. If the withdrawal liability dispute is not concluded by 12 months after the electing person posts the bond or escrow, the electing person must, at the start of each succeeding 12-month period, provide an additional bond or amount held in escrow equal to the sum of the withdrawal liability payments that would otherwise be payable to the plan during that period.

A small employer is an employer which, for the calendar year in which the transaction occurred, and for each of the three preceding years, on average (1) employs no more than 500 employees, and (2) is required to make contributions to the plan on behalf of not more than 250 employees.

Effective Date

The provision is effective for any person that receives a notification of withdrawal liability and demand for payment on or after the date of enactment with respect to a transaction that occurred after December 31, 1998.

**E. Prohibition on Retaliation against Employers Exercising
their Rights to Petition the Federal Government
(sec. 510 of ERISA)**

Present Law

Under ERISA section 510, it is unlawful for any person to discharge, fine, suspend, expel, discipline, or discriminate against a participant or beneficiary for exercising any right to which he is entitled under the provisions of an employee benefit plan, Title I or section 3001 of ERISA, or the Welfare and Pension Plans Disclosure Act, or for the purpose of interfering with the attainment of any right to which a participant may become entitled. It is also unlawful for any person to discharge, fine, suspend, expel or discriminate against any person because he has given information or has testified or is about to testify in any inquiry or proceeding relating to ERISA or the Welfare and Pension Plans Disclosure Act. The civil enforcement provisions under ERISA section 503 are applicable in the enforcement of such provisions.

Explanation of Provision

The provision provides that in the case of a multiemployer plan, it is unlawful for the plan sponsor or any other person to discriminate against any contributing employer for exercising rights under ERISA or for giving information or testifying in an inquiry or proceedings relating to ERISA before Congress. The provision amends the anti-retaliation section of ERISA to provide protection for employers who contribute to multiemployer plans and others. The provision is intended to close a loophole in the existing whistleblower protections. In June 2005, a witness who appeared on behalf of several other companies testified before the Retirement Security & Aging Subcommittee of the Senate Health, Education, Labor & Pensions Committee. Subsequent to that testimony there was an allegation that some of these companies may have been targeted for possible audits.

It is intended that retaliation against any employer who has an obligation to contribute to a plan due to testifying before Congress or exercising his or her rights to petition for redress of grievances would amount to unlawful retaliation under ERISA as amended by the provision. Exercising rights under ERISA, testifying before Congress, and giving information in any inquiry or proceeding relating to this Act are intended to be protected under the provision.

Effective Date

The provision is effective on the date of enactment.

**F. Special Rule for Certain Benefits Funded
under an Agreement Approved by the PBGC**

Present Law

No provision.

Explanation of Provision

The provision provides that in the case of a multiemployer plan that is a party to an agreement that was approved by the PBGC before June 30, 2005, that increases benefits and provides for special withdrawal liability rules, certain benefit increases funded pursuant to the agreement are not subject to the multiemployer plan funding rules under the provision (including the additional funding rules for plans in endangered or critical status) if the multiemployer plan is funded in compliance with the agreement (or any amendment thereto).

Effective Date

The provision is effective on the date of enactment.

**G. Exception from Excise Tax for Certain Multiemployer Pension Plans
(sec. 4971 of the Code)**

Present Law

If a multiemployer plan has an accumulated funding deficiency for a year, an excise tax of five percent generally applies, increasing to 100 percent if contributions sufficient to eliminate the funding deficiency are not made within a certain period.⁸¹

Explanation of Provision

Under the provision, the present-law excise tax does not apply with respect to any accumulated funding deficiency of a multiemployer plan (1) with less than 100 participants; (2) with respect to which the contributing employers participated in a Federal fishery capacity reduction program; (3) with respect to which employers under the plan participated in the Northeast Fisheries Assistance Program; and (4) with respect to which the annual normal cost is less than \$100,000 and the plan is experiencing a funding deficiency on the date of enactment. The tax does not apply to any taxable year beginning before the earlier of (1) the taxable year in which the plan sponsor adopts a rehabilitation plan, or (2) the taxable year that contains January 1, 2009.

Effective Date

The provision is effective for any taxable year beginning before the earlier of (1) the taxable year in which the plan sponsor adopts a rehabilitation plan, or (2) the taxable year that contains January 1, 2009.

⁸¹ Code sec. 4971.

H. Sunset of Multiemployer Plan Funding Provisions

Present Law

No provision.

Explanation of Provision

The provision directs the Secretary of Labor, the Secretary of Treasury, and the Executive Director of the PBGC, not later than December 31, 2011, to conduct a study of the effect of the changes made by the provision on the operation and funding status of multiemployer plans and report the results of the study, including recommendations for legislation, to Congress. The study must include (1) the effect of funding difficulties, funding rules in effect before the date of enactment, and the changes made by the provision on small businesses participating in multiemployer plans; (2) the effect on the financial status of small employers of funding targets set in funding improvement and rehabilitation plans and associated contribution increases, funding deficiencies, excise taxes, withdrawal liability, the possibility of alternative schedules and procedures for financially-troubled employers, and other aspects of the multiemployer system; and (3) the role of the multiemployer pension plan system in helping small employers to offer pension benefits.

The provision provides that the rules applicable to plans in endangered and critical status and the rules relating to the automatic amortization extension and shortfall funding method under the general funding rules for multiemployer plans do not apply to plan years beginning after December 31, 2014. The present-law rules are reinstated for such years except that funding improvement and rehabilitation plans and amortization schedules in effect at the time of the sunset continue.

Effective Date

The provision is effective on the date of enactment.

TITLE III: INTEREST RATE ASSUMPTIONS

A. Extension of Replacement of 30-Year Treasury Rates (secs. 302 and 4006 of ERISA, and sec. 412 of the Code)

The provisions relating to extension of the replacement of the 30-year Treasury rate for purposes of single-employer funding rules are described above, under Title I. The provision relating to extension of the replacement of the 30-year Treasury rate for PBGC premium purposes is described below, under Title IV.

**B. Interest Rate Assumption for Determination of Lump-Sum Distributions
(sec. 205(g) of ERISA and sec. 417(e) of the Code)**

Present law

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

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

Statutory interest and mortality 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 interest rate and an applicable mortality table (as published by the IRS).

The applicable interest rate is the annual interest rate on 30-year Treasury securities for the month before the date of distribution or such other time as prescribed by Treasury regulations. The regulations provide various options for determining the interest rate to be used under the plan, such as the period for which the interest rate will remain constant (“stability period”) and the use of averaging.

The applicable mortality table is a mortality table based on the 1994 Group Annuity Reserving Table (“94 GAR”), projected through 2002.

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.⁸² This restriction is sometimes referred to as the “anticutback” rule and applies to benefits that have already accrued. For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

⁸² Code sec. 411(d)(6); ERISA sec. 204(g).

Explanation of Provision

The provision changes the interest rate and mortality table used in calculating the minimum value of certain optional forms of benefit, such as lump sums.⁸³

Minimum value is calculated using the first, second, and third segment rates as applied under the funding rules, with certain adjustments, for the month before the date of distribution or such other time as prescribed by Treasury regulations. The adjusted first, second, and third segment rates are derived from a corporate bond yield curve prescribed by the Secretary of the Treasury for such month which reflects the yields on investment grade corporate bonds with varying maturities (rather than a 24-month average, as under the minimum funding rules). Thus, the interest rate that applies depends upon how many years in the future a participant's annuity payment will be made. Typically, a higher interest applies for payments made further out in the future.

A transition rule applies for distributions in 2008 through 2011. For distributions in 2008 through 2011, minimum lump-sum values are determined as the weighted average of two values: (1) the value of the lump sum determined under the methodology under present law (the "old" methodology); and (2) the value of the lump sum determined using the methodology applicable for 2008 and thereafter (the "new" methodology). For distributions in 2008, the weighting factor is 80 percent for the lump-sum value determined under the old methodology and 20 percent for the lump-sum determined under the new methodology. For distributions in 2009, the weighting factor is 60 percent for the lump-sum value determined under the old methodology and 40 percent for the lump-sum determined under the new methodology. For distributions in 2010, the weighting factor is 40 percent for the lump-sum value determined under the old methodology and 60 percent for the lump-sum determined under the new methodology. For distributions in 2011, the weighting factor is 20 percent for the lump-sum value determined under the old methodology and 80 percent for the lump-sum determined under the new methodology.

The mortality table that must be used for calculating lump sums under the bill is based on the mortality table required for minimum funding purposes under the bill, modified as appropriate by the Secretary of the Treasury. The Secretary is to prescribe gender-neutral tables for use in determining minimum lump sums.

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

⁸³ Under the provision of the bill relating to plan amendments, if certain requirements are met, a plan amendment to implement the changes made to the minimum value requirements may be made retroactively and without violating the anticutback rule.

**C. Interest Rate Assumption for Applying Benefit Limitations
to Lump-Sum Distributions
(sec. 415(b) of the Code)**

Present Law

Annual benefits payable under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation, or (2) \$175,000 (for 2006). The dollar limit generally applies to a benefit payable in the form of a straight life annuity. If the benefit is not in the form of a straight life annuity (e.g., a lump sum), the benefit generally is adjusted to an equivalent straight life annuity. For purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) the rate applicable in determining minimum lump sums, i.e., the interest rate on 30-year Treasury securities; or (2) the interest rate specified in the plan. In the case of plan years beginning in 2004 or 2005, the interest rate used generally must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate specified in the plan.⁸⁴

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant.⁸⁵ This restriction is sometimes referred to as the “anticutback” rule and applies to benefits that have already accrued. For purposes of the anticutback rule, an amendment is also treated as reducing an accrued benefit if, with respect to benefits accrued before the amendment is adopted, the amendment has the effect of either (1) eliminating or reducing an early retirement benefit or a retirement-type subsidy, or (2) except as provided by Treasury regulations, eliminating an optional form of benefit.

Explanation of Provision

Under the bill, for purposes of adjusting a benefit in a form that is subject to the minimum value rules, such as a lump-sum benefit, the interest rate used generally must be not less than the greater of: (1) 5.5 percent; (2) the rate that provides a benefit of not more than 105 percent of the benefit that would be provided if the rate (or rates) applicable in determining minimum lump sums were used; or (3) the interest rate specified in the plan.⁸⁶

⁸⁴ In the case of a plan under which lump-sum benefits are determined solely as required under the minimum value rules (rather than using an interest rate that results in larger lump-sum benefits), the interest rate specified in the plan is the interest rate applicable under the minimum value rules. Thus, for purposes of applying the benefit limits to lump-sum benefits under the plan, the interest rate used must be not less than the greater of: (1) 5.5 percent; or (2) the interest rate applicable under the minimum value rules.

⁸⁵ Code sec. 411(d)(6); ERISA sec. 204(g).

⁸⁶ Under the provision of the bill relating to plan amendments, if certain requirements are met, a plan amendment to implement the change made to the interest rate used in adjusting a benefit in a form that is subject to the minimum value rules may be made retroactively and without violating the anticutback rule.

Effective Date

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

TITLE IV: PBGC GUARANTEE AND RELATED PROVISIONS

A. PBGC Premiums (sec. 4006 of ERISA)

Present Law

The PBGC

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

Termination of single-employer defined benefit plans

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

A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities. If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the employer may not terminate the plan unless the employer (and members of the employer’s controlled group) meets one of four criteria of financial distress.⁸⁷

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

⁸⁷ The four criteria for a distress termination are: (1) the contributing sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings; (2) the contributing sponsor and every member of the sponsor’s controlled group is being reorganized in bankruptcy or similar State proceeding; (3) the PBGC determines that termination is necessary to allow the employer to pay its debts when due; or (4) the PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the employer’s work force.

Guaranteed benefits

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments (rather than, for example, lump-sum benefits payable to encourage early retirement) is guaranteed.⁸⁸

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

For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is \$3,971.59 per month or \$47,659.08 per year.⁸⁹ The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

The dollar limit is indexed annually for wage inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.⁹⁰

⁸⁸ ERISA sec. 4022(b) and (c).

⁸⁹ The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

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

⁹⁰ The phase in does not apply if the benefit is less than \$20 per month.

PBGC premiums

In general

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

Flat rate premium

Under the Deficit Reduction Act of 2005,⁹¹ the flat-rate premium is \$30 for plan years beginning after December, 31, 2005, with indexing after 2006 based on increases in average wages.

Variable rate premium

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

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

Termination premium

Under the Deficit Reduction Act of 2005, a new premium generally applies in the case of certain plan terminations occurring after 2005 and before 2011. A premium of \$1,250 per participant is imposed generally for the year of the termination and each of the following two years. The premium applies in the case of a plan termination by the PBGC or a distress termination due to reorganization in bankruptcy, the inability of the employer to pay its debts when due, or a determination that a termination is necessary to avoid unreasonably burdensome

⁹¹ Pub. L. No. 109-171, enacted February 8, 2006.

pension costs caused solely by a decline in the workforce. In the case of a termination due to reorganization, the liability for the premium does not arise until the employer is discharged from the reorganization proceeding. The premium does not apply with respect to a plan terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005.

Explanation of Provision

Variable rate premium

For 2006 and 2007, the bill extends the present-law rule under which, in determining the amount of unfunded vested benefits for variable rate premium purposes, the interest rate used is 85 percent of the annual rate of interest determined by the Secretary of the Treasury on amounts invested conservatively in long term investment-grade corporate bonds for the month preceding the month in which the plan year begins.

Beginning in 2008, the determination of unfunded vested benefits for purposes of the variable rate premium is modified to reflect the changes to the funding rules of the provision. Thus, under the provision, unfunded vested benefits are equal to the excess (if any) of (1) the plan's funding target⁹² for the year determined as under the minimum funding rules, but taking into account only vested benefits over (2) the fair market value of plan assets. In valuing unfunded vested benefits the interest rate is the first, second, and third segment rates which would be determined under the funding rules of the provision, if the segment rates were based on the yields of corporate bond rates, rather than a 24-month average of such rates. Under the bill, deductible contributions are no longer limited by the full funding limit; thus, the rule providing that no variable rate premium is required if contributions for the prior plan year were at least equal to the full funding limit no longer applies under the provision.

Termination premium

The bill makes permanent the termination premium enacted in the Deficit Reduction Act of 2005.

Effective Date

The extension of the present-law interest rate for purposes of calculating the variable rate premium is effective for plan years beginning in 2006 and 2007. The modifications to the variable rate premium are effective for plan years beginning after December 31, 2007. The provision extending the termination premium is effective on the date of enactment.

⁹² The assumptions used in determining funded target are the same as under the minimum funding rules. Thus, for a plan in at-risk status, the at-risk assumptions are used.

B. Special Funding Rules for Plans Maintained by Commercial Airlines

Present Law

Minimum funding rules in general

Single-employer defined benefit pension plans are subject to minimum funding requirements under the Employee Retirement Income Security Act of 1974 (“ERISA”) and the Internal Revenue Code (the “Code”).⁹³ The amount of contributions required for a plan year under the minimum funding rules is generally the amount needed to fund benefits earned during that year plus that year’s portion of other liabilities that are amortized over a period of years, such as benefits resulting from a grant of past service credit. The amount of required annual contributions is determined under one of a number of acceptable actuarial cost methods. Additional contributions are required under the deficit reduction contribution rules in the case of certain underfunded plans. No contribution is required under the minimum funding rules in excess of the full funding limit. A detailed description of the present-law funding rules is provided in Title I, above.

Notice of certain plan amendments

A notice requirement must be met if an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual. In that case, the plan administrator must furnish a written notice concerning the amendment. Notice may also be required if a plan amendment eliminates or reduces an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide the notice to any participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment (and to any employee organization representing affected participants). The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information to allow recipients to understand the effect of the amendment. In the case of a single-employer plan, the plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment. In the case of a multiemployer plan, the notice is generally required to be provided 15 days before the effective date of the plan amendment.

PBGC termination insurance program

The minimum funding requirements permit an employer to fund defined benefit plan benefits over a period of time. Thus, it is possible that a plan may be terminated at a time when plan assets are not sufficient to provide all benefits accrued by employees under the plan. In order to protect plan participants from losing retirement benefits in such circumstances, the PBGC guarantees basic benefits under most defined benefit plans. When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset

⁹³ Code sec. 412. The minimum funding rules also apply to multiemployer plans, but the rules for multiemployer plans differ in various respects from the rules applicable to single-employer plans.

allocation, and recovery on the PBGC's employer liability claim. There is a dollar limit on the amount of otherwise guaranteed benefits based on the year in which the plan terminates. For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is \$3,971.59 per month or \$47,659.08 per year.⁹⁴ The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65. In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.⁹⁵

Termination premiums

Under the Deficit Reduction Act of 2005, a new premium generally applies in the case of certain plan terminations occurring after 2005 and before 2011. A premium of \$1,250 per participant is imposed generally for the year of the termination and each of the following two years. The premium applies in the case of a plan termination by the PBGC or a distress termination due to reorganization in bankruptcy, the inability of the employer to pay its debts when due, or a determination that a termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the workforce. In the case of a termination due to reorganization, the liability for the premium does not arise until the employer is discharged from the reorganization proceeding. The premium does not apply with respect to a plan terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005.

Minimum coverage requirements

The Code imposes minimum coverage requirements on qualified retirement plans in order to ensure that plans cover a broad cross section of employees.⁹⁶ In general, the minimum coverage requirements are satisfied if one of the following criteria are met: (1) the plan benefits at least 70 percent of employees who are not highly compensated employees; (2) the plan benefits a percentage of employees who are not highly compensated employees which is at least

⁹⁴ The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

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

⁹⁵ The phase in does not apply if the benefit is less than \$20 per month.

⁹⁶ Code sec. 410(b).

70 percent of the percentage of highly compensated employees participating under the plan; or (3) the plan meets the average benefits test.

Certain employees may be disregarded in applying the minimum coverage requirements. Under one exclusion, in the case of a plan established or maintained pursuant to an agreement which the Secretary of Labor finds to be a collective bargaining agreement between air pilots represented in accordance with title II of the Railway Labor Act and one or more employers, all employees not covered by such agreement may be disregarded. This exclusion does not apply in the case of a plan which provides contributions or benefits for employees whose principal duties are not customarily performed aboard aircraft in flight.

Alternative deficit reduction contribution for certain plans

Under present law, certain employers (“applicable employers”) may elect a reduced amount of additional required contribution under the deficit reduction contribution rules (an “alternative deficit reduction contribution”) with respect to certain plans for applicable plan years. An applicable plan year is a plan year beginning after December 27, 2003, and before December 28, 2005, for which the employer elects a reduced contribution. If an employer so elects, the amount of the additional deficit reduction contribution for an applicable plan year is the greater of: (1) 20 percent of the amount of the additional contribution that would otherwise be required; or (2) the additional contribution that would be required if the deficit reduction contribution for the plan year were determined as the expected increase in current liability due to benefits accruing during the plan year.

An applicable employer is an employer that is: (1) a commercial passenger airline; (2) primarily engaged in the production or manufacture of a steel mill product, or the processing of iron ore pellets; or (3) an organization described in section 501(c)(5) that established the plan for which an alternative deficit reduction contribution is elected on June 30, 1955.

Explanation of Provision

In general

The provision provides special funding rules for certain eligible plans. For purposes of the provision, an eligible plan is a single-employer defined benefit pension plan sponsored by an employer that is a commercial passenger airline or the principal business of which is providing catering services to a commercial passenger airline.

The plan sponsor of an eligible plan may make one of two alternative elections. In the case of a plan that meets certain benefit accrual and benefit increase restrictions, an election allowing a 17-year amortization of the plan’s unfunded liability is available. A plan that does not meet such requirements may elect to use a 10-year amortization period in amortizing the plan’s shortfall amortization base for the first taxable year beginning in 2008.

Election for plans that meet benefit accrual and benefit increase restriction requirements

In general

Under the provision, if an election of a 17-year amortization period is made with respect to an eligible plan for a plan year (an “applicable” plan year), the minimum required contribution is determined under a special method.⁹⁷ If minimum required contributions as determined under the provision are made: (1) for an applicable plan year beginning before January 1, 2008 (for which the present-law funding rules apply), the plan does not have an accumulated funding deficiency; and (2) for an applicable plan year beginning on or after January 1, 2008 (for which the funding rules under the provision apply), the minimum required contribution is the contribution determined under the provision.

The employer may select either a plan year beginning in 2006 or 2007 as the first plan year to which the election applies. The election applies to such plan year and all subsequent plan years, unless the election is revoked with the approval of the Secretary of the Treasury. The election must be made (1) no later than December 31, 2006, in the case of an election for a plan year beginning in 2006, or (2) not later than December 31, 2007, in the case of a plan year beginning in 2007. An election under the provision must be made in such manner as prescribed by the Secretary of the Treasury. The employer may change the plan year with respect to the plan by specifying a new plan year in the election. Such a change in plan year does not require approval of the Secretary of the Treasury.

Determination of required contribution

Under the provision, the minimum required contribution for any applicable plan year during the amortization period is the amount required to amortize the plan’s unfunded liability, determined as of the first day of the plan year, in equal annual installments over the remaining amortization period. For this purpose, the amortization period is the 17-plan-year period beginning with the first applicable plan year. Thus, the annual amortization amount is redetermined each year, based on the plan’s unfunded liability at that time and the remainder of the amortization period. For any plan years beginning after the end of the amortization period, the plan is subject to the generally applicable minimum funding rules (as provided under the bill, including the benefit limitations applicable to underfunded plans). The plan’s prefunding balance and funding standard carryover balance as of the first day of the first year beginning after the end of the amortization period is zero.⁹⁸

⁹⁷ Any charge or credit in the funding standard account determined under the present-law rules or any prefunding balance or funding standard carryover balance (determined under the funding provisions of the bill) as of the end of the last year preceding the first applicable year is reduced to zero.

⁹⁸ If an election to use the special method is revoked before the end of the amortization period, the plan is subject to the generally applicable minimum funding rules beginning with the first plan year for which the election is revoked, and the plan’s prefunding balance as of the beginning of that year is zero.

Any waived funding deficiency as of the day before the first day of the first applicable plan year is deemed satisfied and the amount of such waived funding deficiency must be taken into account in determining the plan's unfunded liability under the provision. Any plan amendment adopted to satisfy the benefit accrual restrictions of the provision (discussed below) or any increase in benefits provided to such plan's participants under a defined contribution or multiemployer plan will not be deemed to violate the prohibition against benefit increases during a waiver period.⁹⁹

For purposes of the provision, a plan's unfunded liability is the unfunded accrued liability under the plan, determined under the unit credit funding method. As under present law, minimum required contributions (including the annual amortization amount) under the provision must be determined using actuarial assumptions and methods, each of which is reasonable (taking into account the experience of the plan and reasonable expectations), or which, in the aggregate, result in a total plan contribution equivalent to a contribution that would be obtained if each assumption and method were reasonable. The assumptions are required also to offer the actuary's best estimate of anticipated experience under the plan. Under the election, a rate of interest of 8.85 percent is used in determining the plan's accrued liability. The value of plan assets used must be the fair market value.

If any applicable plan year with respect to an eligible plan using the special method includes the date of enactment of the provision and a plan was spun off from such eligible plan during the plan year, but before the date of enactment, the minimum required contribution under the special method for the applicable plan year is an aggregate amount determined as if the plans were a single plan for that plan year (based on the full 12-month plan year in effect prior to the spin off). The employer is to designate the allocation of the aggregate amount between the plans for the applicable plan year.

Benefit accrual and benefit increase restrictions

Benefit accrual restrictions. - Under the provision, effective as of the first day of the first applicable plan year and at all times thereafter while an election under the provision is in effect, an eligible plan must include two accrual restrictions. First, the plan must provide that, with respect to each participant: (1) the accrued benefit, any death or disability benefit, and any social security supplement are frozen at the amount of the benefit or supplement immediately before such first day; and (2) all other benefits under the plan are eliminated. However, such freezing or elimination of benefits or supplements is required only to the extent that it would be permitted under the anticutback rule if implemented by a plan amendment adopted immediately before such first day.

Second, if an accrued benefit of a participant has been subject to the limitations on benefits under section 415 of the Code and would otherwise be increased if such limitation is increased, the plan must provide that, effective as of the first day of the first applicable plan year

⁹⁹ ERISA sec. 304(b); Code sec. 412(f).

(or, if later, the date of enactment) any such increase will not take effect. The plan does not fail to meet the anticutback rule solely because the plan is amended to meet this requirement.

Benefit increase restriction. – No applicable benefit increase under an eligible plan may take effect at any time during the period beginning on July 26, 2005, and ending on the day before the first day of the first applicable plan year. For this purpose, an applicable benefit increase is any increase in liabilities of the plan by plan amendment (or otherwise as specified by the Secretary) which would occur by reason of: (1) any increase in benefits; (2) any change in the accrual of benefits; or (3) any change in the rate at which benefits become nonforfeitable under the plan.

Exception for imputed disability service.– The benefit accrual and benefit increase restrictions do not apply to any accrual or increase with respect to imputed serviced provided to a participant during any period of the participant’s disability occurring on or after the effective date of the plan amendment providing for the benefit accrual restrictions (on or after July 26, 2005, in the case of benefit increase restrictions) if the participant was: (1) was receiving disability benefits as of such date or (2) was receiving sick pay and subsequently determined to be eligible for disability benefits as of such date.

Rules relating to PBGC guarantee and plan terminations

Under the provision, if a plan to which an election applies is terminated before the end of the 10-year period beginning on the first day of the first applicable plan year, certain aspects of the PBGC guarantee provisions are applied as if the plan terminated on the first day of the first applicable plan year. Specifically, the amount of guaranteed benefits payable by the PBGC is determined based on plan assets and liabilities as of the assumed termination date. The difference between the amount of guaranteed benefits determined as of the assumed termination date and the amount of guaranteed benefits determined as of the actual termination date is to be paid from plan assets before other benefits.

The provision of the bill under which defined benefit plans that are covered by the PBGC insurance program are not taken into account in applying the overall limit on deductions for contributions to combinations of defined benefit and defined contribution plans, does not apply to an eligible plan to which the special method applies. Thus, the overall deduction limit applies.

In the case of notice required with respect to an amendment that is made to an eligible plan maintained pursuant to one or more collective bargaining agreements in order to comply with the benefit accrual and benefit increase restrictions under the provision, the provision allows the notice to be provided 15 days before the effective date of the plan amendment.

Termination premiums

If a plan terminates during the five-year period beginning on the first day of the first applicable plan year, termination premiums are imposed at a rate of \$2,500 per participant (in lieu of the present-law \$1,250 amount). The increased termination premium applies notwithstanding that a plan was terminated during bankruptcy reorganization proceedings pursuant to a bankruptcy filing before October 18, 2005 (i.e., the present-law grandfather rule does not apply).

The Secretary of Labor may waive the additional termination premium if the Secretary determines that the termination occurred as the result of extraordinary circumstances such as a terrorist attack or other similar event. It is intended that extraordinary circumstances means a substantial, system-wide adverse effect on the airline industry such as the terrorist attack which occurred on September 11, 2001. It is intended that the waiver of the additional premiums occur only in rare and unpredictable events. Extraordinary circumstances would not include a mere economic event such as the high price of oil or fuel, or a downturn in the market.

Alternative election in the case of plans not meeting benefit accrual and benefit increase restrictions

In lieu of the election above, a plan sponsor may elect, for the first taxable year beginning in 2008, to amortize the shortfall amortization base for such taxable year over a period of 10 plan years (rather than seven plan years) beginning with such plan year. Under such election, the benefit accrual, benefit increase and other restrictions discussed above do not apply. This 10-year amortization election must be made by December 31, 2007.

Authority of Treasury to disqualify successor plans

If either election is made under the provision and the eligible plan is maintained by an employer that establishes or maintains one or more other single-employer defined benefit plans, and such other plans in combination provide benefit accruals to any substantial number of successor employees, the Secretary of Treasury may disqualify such successor plans unless all benefit obligations of the eligible plan have been satisfied. Successor employees include any employee who is or was covered by the eligible plan and any employee who performs substantially the same type of work with respect to the same business operations as an employee covered by the eligible plan.

Alternative deficit reduction contribution for certain plans

In the case of an employer which is a commercial passenger airline, the provision extends the alternative deficit reduction contributions rules to plan years beginning before December 28, 2007.

Application of minimum coverage rules

In applying the minimum coverage rules to a plan, management pilots who are not represented in accordance with title II of the Railway Labor Act are treated as covered by a collective bargaining agreement if the management pilots manage the flight operations of air pilots who are so represented and the management pilots are, pursuant to the terms of the agreement, included in the group of employees benefiting under the plan.

The exclusion under the minimum coverage rules for air pilots represented in accordance with title II of the Railway Labor Act does not apply in the case of a plan which provides contributions or benefits for employees whose principal duties are not customarily performed aboard an aircraft in flight (other than management pilots described above).

Effective Date

The provision is effective for plan years ending after the date of enactment except that the modifications to the minimum coverage rules apply to years beginning before, on, or after the date of enactment.

**C. Limitations on PBGC Guarantee of Shutdown and Other Benefits
(sec. 4022 of ERISA)**

Present Law

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

Under present law, defined benefit pension plans are not permitted to provide “layoff” benefits (i.e., severance benefits).¹⁰⁰ However, defined benefit pension plans may provide subsidized early retirement benefits, including early retirement window benefits.¹⁰¹

Within certain limits, the PBGC guarantees any retirement benefit that was vested on the date of plan termination (other than benefits that vest solely on account of the termination), and any survivor or disability benefit that was owed or was in payment status at the date of plan termination.¹⁰² Generally only that part of the retirement benefit that is payable in monthly installments is guaranteed.¹⁰³

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

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

Explanation of Provision

Under the bill, the PBGC guarantee applies to unpredictable contingent event benefits as if a plan amendment had been adopted on the date the event giving rise to the benefits occurred. An unpredictable contingent event benefit is defined as under the benefit limitations applicable to single-employer plans (described above) and means a benefit payable solely by reason of (1) a plant shutdown (or similar event as determined by the Secretary of the Treasury), or (2) an event other than the attainment of any age, performance of any service, receipt or derivation of any compensation, or occurrence of death or disability.

¹⁰⁰ Treas. Reg. sec. 1.401-1(b)(1)(i).

¹⁰¹ Treas. Reg. secs. 1.401(a)(4)-3(f)(4) and 1.411(a)-7(c).

¹⁰² ERISA sec. 4022(a).

¹⁰³ ERISA sec. 4022(b) and (c).

Effective Date

The provision applies to benefits that become payable as a result of an event which occurs after July 26, 2005.

**D. Rules Relating to Bankruptcy of the Employer
(secs. 4022 and 4044 of ERISA)**

Present Law

Guaranteed benefits

When an underfunded plan terminates, the amount of benefits that the PBGC will pay depends on legal limits, asset allocation, and recovery on the PBGC's employer liability claim. The PBGC guarantee applies to "basic benefits." Basic benefits generally are benefits accrued before a plan terminates, including (1) benefits at normal retirement age; (2) most early retirement benefits; (3) disability benefits for disabilities that occurred before the plan was terminated; and (4) certain benefits for survivors of plan participants. Generally only that part of the retirement benefit that is payable in monthly installments is guaranteed.¹⁰⁴

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

For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a single life annuity is \$3,971.59 per month or \$47,659.08 per year.¹⁰⁵ The dollar limit is indexed annually for inflation. The guaranteed amount is reduced for benefits starting before age 65.

In the case of a plan or a plan amendment that has been in effect for less than five years before a plan termination, the amount guaranteed is phased in by 20 percent a year.¹⁰⁶

¹⁰⁴ ERISA sec. 4022(b) and (c).

¹⁰⁵ The PBGC generally pays the greater of the guaranteed benefit amount and the amount that was covered by plan assets when it terminated. Thus, depending on the amount of assets in the terminating plan, participants may receive more than the amount guaranteed by PBGC.

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

¹⁰⁶ The phase in does not apply if the benefit is less than \$20 per month.

Asset allocation

ERISA contains rules for allocating the assets of a single-employer plan when the plan terminates. Plan assets available to pay for benefits under a terminating plan include all plan assets remaining after subtracting all liabilities (other than liabilities for future benefit payments), paid or payable from plan assets under the provisions of the plan. On termination, the plan administrator must allocate plan assets available to pay for benefits under the plan in the manner prescribed by ERISA. In general, plan assets available to pay for benefits under the plan are allocated to six priority categories. If the plan has sufficient assets to pay for all benefits in a particular priority category, the remaining assets are allocated to the next lower priority category. This process is repeated until all benefits in the priority categories are provided or until all available plan assets have been allocated.

Explanation of Provision

Under the bill, the amount of guaranteed benefits payable by the PBGC is frozen when a contributing sponsor enters bankruptcy or a similar proceeding.¹⁰⁷ If the plan terminates during the contributing sponsor's bankruptcy, the amount of guaranteed benefits payable by the PBGC is determined based on plan provisions, salary, service, and the guarantee in effect on the date the employer entered bankruptcy. The priority among participants for purposes of allocating plan assets and employer recoveries to non-guaranteed benefits in the event of plan termination is determined as of the date the sponsor enters bankruptcy or a similar proceeding.

A contributing sponsor of a single-employer plan is required to notify the plan administrator when the sponsor enters bankruptcy or a similar proceeding. Within a reasonable time after a plan administrator knows or has reason to know that a contributing sponsor has entered bankruptcy (or similar proceeding), the administrator is required to notify plan participants and beneficiaries of the bankruptcy and the limitations on benefit guarantees if the plan is terminated while underfunded, taking into account the bankruptcy.

The Secretary of Labor is to prescribe the form and manner of notices required under this provision. The notice is to be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent that such form is reasonably accessible to the applicable individual.

The Secretary of Labor may assess a civil penalty of up to \$100 a day for each failure to provide the notice required by the provision. Each violation with respect to any single participant or beneficiary is treated as a separate violation.

¹⁰⁷ For purposes of the provision, a contributing sponsor is considered to have entered bankruptcy if the sponsor files or has had filed against it a petition seeking liquidation or reorganization in a case under title 11 of the United States Code or under any similar Federal law or law of a State or political subdivision.

Effective Date

The provision is effective with respect to Federal bankruptcy or similar proceedings or arrangements for the benefit of creditors which are initiated on or after the date that is 30 days after enactment.

E. PBGC Premiums for Small Plans
(sec. 4006 of ERISA)

Present Law

Under present law, the Pension Benefit Guaranty Corporation (“PBGC”) provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay benefits promised under the plan. The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit pension plans. The amount of the required annual PBGC premium for a single-employer plan is generally a flat rate premium of \$19 per participant and an additional variable-rate premium based on a charge of \$9 per \$1,000 of unfunded vested benefits. Unfunded vested benefits under a plan generally means (1) the unfunded current liability for vested benefits under the plan, over (2) the value of the plan’s assets, reduced by any credit balance in the funding standard account. No variable-rate premium is imposed for a year if contributions to the plan were at least equal to the full funding limit.

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than five years, and with respect to benefit increases from a plan amendment that was in effect for less than five years before termination of the plan.

Explanation of Provision

In the case of a plan of a small employer, the per participant variable-rate premium is no more than \$5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For purposes of the provision, a small employer is a contributing sponsor that, on the first day of the plan year, has 25 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are to be taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributed, employees of all contributing sponsors (and their controlled group members) are to be taken into account in determining whether the plan was a plan of a small employer. For example, under the provision, in the case of a plan with 20 participants, the total variable rate premium is not more than \$2,000, that is, $(20 \times \$5) \times 20$.

Effective Date

The provision applies to plan years beginning after December 31, 2006.

**F. Authorization for PBGC to Pay Interest on Premium Overpayment Refunds
(sec. 4007(b) of ERISA)**

Present Law

The PBGC charges interest on underpayments of premiums, but is not authorized to pay interest on overpayments.

Explanation of Provision

The provision allows the PBGC to pay interest on overpayments made by premium payors. Interest paid on overpayments is to be calculated at the same rate and in the same manner as interest charged on premium underpayments.

Effective Date

The provision is effective with respect to interest accruing for periods beginning not earlier than the date of enactment.

**G. Rules for Substantial Owner Benefits in Terminated Plans
(secs. 4021, 4022, 4043, and 4044 of ERISA)**

Present Law

Under present law, the Pension Benefit Guaranty Corporation (“PBGC”) provides participants and beneficiaries in a defined benefit pension plan with certain minimal guarantees as to the receipt of benefits under the plan in case of plan termination. The employer sponsoring the defined benefit pension plan is required to pay premiums to the PBGC to provide insurance for the guaranteed benefits. In general, the PBGC will guarantee all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. The amount of the guaranteed benefit is subject to certain limitations. One limitation is that the plan (or an amendment to the plan which increases benefits) must be in effect for 60 months before termination for the PBGC to guarantee the full amount of basic benefits for a plan participant, other than a substantial owner. In the case of a substantial owner, the guaranteed basic benefit is phased in over 30 years beginning with participation in the plan. A substantial owner is one who owns, directly or indirectly, more than 10 percent of the voting stock of a corporation or all the stock of a corporation. Special rules restricting the amount of benefit guaranteed and the allocation of assets also apply to substantial owners.

Explanation of Provision

The provision provides that the 60-month phase-in of guaranteed benefits applies to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest (“majority owner”), the phase-in occurs over a 10-year period and depends on the number of years the plan has been in effect. The majority owner’s guaranteed benefit is limited so that it cannot be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets apply to substantial owners, other than majority owners, in the same manner as other participants.

Effective Date

The provision is effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC, after December 31, 2005.

**H. Acceleration of PBGC Computation of Benefits
Attributable to Recoveries from Employers
(secs. 4022(c) and 4062(c) of ERISA)**

Present Law

In general

The Pension Benefit Guaranty Corporation (“PBGC”) provides insurance protection for participants and beneficiaries under certain defined benefit pension plans by guaranteeing certain basic benefits under the plan in the event the plan is terminated with insufficient assets to pay promised benefits.¹⁰⁸ The guaranteed benefits are funded in part by premium payments from employers who sponsor defined benefit plans. In general, the PBGC guarantees all basic benefits which are payable in periodic installments for the life (or lives) of the participant and his or her beneficiaries and are non-forfeitable at the time of plan termination. For plans terminating in 2006, the maximum guaranteed benefit for an individual retiring at age 65 and receiving a straight life annuity is \$3971.59 per month, or \$47,659.08 per year.

The PBGC pays plan benefits, subject to the guarantee limits, when it becomes trustee of a terminated plan. The PBGC also pays amounts in addition to the guarantee limits (“additional benefits”) if there are sufficient plan assets, including amounts recovered from the employer for unfunded benefit liabilities and contributions owed to the plan. The employer (including members of its controlled group) is statutorily liable for these amounts.

Plan underfunding recoveries

The PBGC’s recoveries on its claims for unfunded benefit liabilities are shared between the PBGC and plan participants. The amounts recovered are allocated partly to the PBGC to help cover its losses for paying unfunded guaranteed benefits and partly to participants to help cover the loss of benefits that are above the PBGC’s guarantees and are not funded. In determining the portion of the recovered amounts that will be allocated to participants, present law specifies the use of a recovery ratio based on plan terminations during a specified period, rather than the actual amount recovered for each specific plan. The recovery ratio that applies to a plan includes the PBGC’s actual recovery experience for plan terminations in the five-Federal fiscal year period immediately preceding the Federal fiscal year in which falls the notice of intent to terminate for the particular plan.

The recovery ratio is used for all but very large plans taken over by the PBGC. For a very large plan (i.e., a plan for which participants’ benefit losses exceed \$20 million) actual recovery amounts with respect to the specific plan are used to determine the portion of the amounts recovered that will be allocated to participants.

¹⁰⁸ The PBGC termination insurance program does not cover plans of professional service employers that have fewer than 25 participants.

Recoveries for due and unpaid employer contributions

Amounts recovered from an employer for contributions owed to the plan are treated as plan assets and are allocated to plan benefits in the same manner as other assets in the plan's trust on the plan termination date. The amounts recovered are determined on a plan-specific basis rather than based on an historical average recovery ratio.

Explanation of Provision

The bill changes the five-year period used to determine the recovery ratio for unfunded benefit liabilities so that the period begins two years earlier. Thus, under the bill, the recovery ratio that applies to a plan includes the PBGC's actual recovery experience for plan terminations in the five-Federal fiscal year period ending with the third fiscal year preceding the fiscal year in which falls the notice of intent to terminate for the particular plan.

In addition, the provision creates a recovery ratio for determining amounts recovered for contributions owed to the plan, based on the PBGC's recovery experience over the same five-year period.

The provision does not apply to very large plans (i.e., plans for which participants' benefit losses exceed \$20 million). As under present law, in the case of a very large plan, actual amounts recovered for unfunded benefit liabilities and for contributions owed to the plan are used to determine the amount available to provide additional benefits to participants.

Effective Date

The provision is effective for any plan termination for which notices of intent to terminate are provided (or, in the case of a termination by the PBGC, a notice of determination that the plan must be terminated is issued) on or after the date that is 30 days after the date of enactment.

**I. Treatment of Certain Plans Where There is a Cessation
or Change in Membership of a Controlled Group
(sec. 4041(b) of ERISA)**

Present Law

An employer may voluntarily terminate a single-employer plan only in a standard termination or a distress termination. A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities. Benefit liabilities are defined generally as the present value of all benefits due under the plan (this amount is referred to as “termination liability”). This present value is determined using interest and mortality assumptions prescribed by the PBGC.

Explanation of Provision

Under the bill, if: (1) there is a transaction or series of transactions which result in a person ceasing to be a member of a controlled group; (2) such person, immediately before the transaction or series of transactions maintained a single-employer defined benefit plan which is fully funded then the interest rate used in determining whether the plan is sufficient for benefit liabilities or to otherwise assess plan liabilities for purposes of section 4041(b) or section 4042(a)(4) shall not be less than the interest rate used in determining whether the plan is fully funded.

The provision does not apply to any transaction or series of transactions unless (1) any employer maintaining the plan immediately before or after such transactions or series of transactions (a) has a outstanding senior unsecured debt instrument which is rated investment grade by each of the nationally recognized statistical rating organizations for corporate bonds that has issued a credit rating for such instrument, or (b) if no such debt instrument of such employer has been rated by such an organization but one or more of such organizations has made an issuer credit rating for such employer, all such organizations which have so rated the employer have rated such employer investment grade and (2) the employer maintaining the plan after the transaction or series of transaction employs at least 20 percent of the employees located within United States who were employed by such employer immediately before the transaction or series of transactions.

The provision does not apply in the case of determinations of liabilities by the PBGC or a court if the plan is terminated within two years of the transaction (or first transaction in a series of transactions).

For purposes of the provision, a plan is considered fully funded with respect to a transaction or series of transactions if (1) in the case of a transaction or series of transactions which occur in a plan year beginning before January 1, 2008, the funded current liability percentage for the plan year (determined under the minimum funding rules) is at least 100 percent, or (2) in the case of a transaction or series of transactions which occur on or after January 1, 2008, the funding target attainment percentage (as determined under the minimum funding rules) as of the valuation date for the plan year is at least 100 percent.

Effective Date

The provision applies to transactions or series of transactions occurring on or after the date of enactment.

J. Missing Participants (sec. 4050 of ERISA)

Present Law

In the case of a defined benefit pension plan that is subject to the plan termination insurance program under Title IV of the Employee Retirement Income Security Act of 1974 (“ERISA”), is maintained by a single employer, and terminates under a standard termination, the plan administrator generally must purchase annuity contracts from a private insurer to provide the benefits to which participants are entitled and distribute the annuity contracts to the participants.

If the plan administrator of a terminating single employer plan cannot locate a participant after a diligent search (a “missing participant”), the plan administrator may satisfy the distribution requirement only by purchasing an annuity from an insurer or transferring the participant’s designated benefit to the Pension Benefit Guaranty Corporation (“PBGC”), which holds the benefit of the missing participant as trustee until the PBGC locates the missing participant and distributes the benefit.¹⁰⁹

The PBGC missing participant program is not available to multiemployer plans or defined contribution plans and other plans not covered by Title IV of ERISA.

Explanation of Provision

Under the bill, the PBGC is directed to prescribe rules for terminating multiemployer plans similar to the present-law missing participant rules applicable to terminating single-employer plans that are subject to Title IV of ERISA.

In addition, under the bill, plan administrators of certain types of plans not subject to the PBGC termination insurance program under present law are permitted, but not required, to elect to transfer missing participants’ benefits to the PBGC upon plan termination. Specifically, the provision extends the missing participants program (in accordance with regulations) to defined contribution plans, defined benefit pension plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit pension plans that provide benefits based upon the separate accounts of participants and therefore are treated as defined contribution plans under ERISA.

Effective Date

The provision is effective for distributions made after final regulations implementing the provision are prescribed.

¹⁰⁹ Secs. 4041(b)(3)(A) and 4050 of ERISA.

**K. Director of the PBGC
(secs. 4002 and 4003 of ERISA)**

Present Law

The PBGC is a corporation within the Department of Labor. In carrying out its functions, the PBGC is administered by the chairman of the board of directors in accordance with the policies established by the board. The board of directors consists of the Secretaries of Labor, Treasury and Commerce.¹¹⁰ The Secretary of Labor is the chairman of the board. The executive director of the PBGC is selected by the chairman of the board.

The PBGC is authorized to make such investigations as it deems necessary to enforce any provisions of title IV of ERISA or any rule or regulation thereunder. For the purpose of any such investigation (or any other proceeding under title IV or ERISA), any member of the board of directors or any officer designated by the chairman of the board may administer oaths, subpoena witnesses and take other actions as provided by ERISA as the corporation deems relevant or material to the inquiry.¹¹¹

Explanation of Provision

The bill provides that, in carrying out its functions, the PBGC will be administered by a Director, who is appointed by the President by and with the advice and consent of the Senate. The Director is to act in accordance with the policies established by the PBGC board. The Senate Committees on Finance and on Health, Education, Labor, and Pensions are given joint jurisdiction over the nomination of a person nominated by the President to be Director of the PBGC. If one of such Committees votes to order reported such a nomination, the other such Committee is to report on the nomination within 30 calendar days, or it is automatically discharged.¹¹²

The Director, and any officer designated by the chairman, is given the authority with respect to investigations that is provided under present law to members of the PBGC board and officers designated by the chairman of the board.

¹¹⁰ ERISA sec. 4002.

¹¹¹ ERISA sec. 4003.

¹¹² The provision relating to the Senate committees is treated as an exercise of rulemaking power of the Senate and is deemed a part of the rules of the Senate. It is applicable only with respect to the procedure to be followed in the case of a nomination of the Director of the PBGC and it supersedes other Senate rules only to the extent that it is inconsistent with such rules. The provision does not change the constitutional right of the Senate to change its rules (so far as relating to the procedure of the Senate) at any time, in the same manner and to the same extent as in the case of any other rule of the Senate.

The Director is to be compensated at the rate of compensation provided under Level III of the Executive Schedule.¹¹³ Effective January 1, 2006, such annual rate of pay is \$152,000.

Effective Date

The provision is effective on the date of enactment. The term of the individual serving as Executive Director of the PBGC on the date of enactment expires on the date of enactment. Such individual, or any other individual, may serve as interim Director of the PBGC until an individual is appointed as Director in accordance with the provision.

¹¹³ 5 U.S.C. sec. 5314.

L. Inclusion of Information in the PBGC Annual Report
(sec. 4008 of ERISA)

Present Law

As soon as practicable after the close of each fiscal year, the PBGC is required to transmit to the President and Congress a report relative to the conduct of its business for the year. The report must include (1) financial statements setting forth its finances and the result of its operations and (2) an actuarial evaluation of the expected operations and status of the four revolving funds used by the PBGC in carrying out its operations.

Explanation of Provision

Under the bill, additional information is required to be provided in the PBGC's annual report. The report must include (1) a summary of the Pension Insurance Modeling System microsimulation model, including the specific simulation parameters, specific initial values, temporal parameters, and policy parameters used to calculate the PBGC's financial statements; (2) a comparison of (a) the average return on investments earned with respect to assets invested by the PBGC for the year to which the report relates and (b) an amount equal to 60 percent of the average return on investment for the year in the Standard & Poor's 500 Index, plus 40 percent of the average return on investment for such year in the Lehman Aggregate Bond Index (or in a similar fixed income index), and (3) a statement regarding the deficit or surplus for the year that the PBGC would have had if it had earned the return described in (2) with respect to its invested assets.

Effective Date

The provision is effective on the date of enactment.

TITLE V: DISCLOSURE

A. Defined Benefit Plan Funding Notice (secs. 101(f) and 4011 of ERISA)

Present Law

Defined benefit pension plans are generally required to meet certain minimum funding requirements. These requirements are designed to help ensure that such plans are adequately funded. In addition, the Pension Benefit Guaranty Corporation (“PBGC”) guarantees benefits under defined benefit pension plans, subject to limits.

Certain notices must be provided to participants in a single-employer defined benefit pension plan relating to the funding status of the plan. For example, ERISA requires an employer of a single-employer defined benefit plan to notify plan participants if the employer fails to make required contributions (unless a request for a funding waiver is pending).¹¹⁴ In addition, in the case of an underfunded single-employer plan for which PBGC variable rate premiums are required, the plan administrator generally must notify plan participants of the plan’s funding status and the limits on the PBGC benefit guarantee if the plan terminates while underfunded.¹¹⁵

Effective for plan years beginning after December 31, 2004, the plan administrator of a multiemployer defined benefit pension plan must provide an annual funding notice to: (1) each participant and beneficiary; (2) each labor organization representing such participants or beneficiaries; (3) each employer that has an obligation to contribute under the plan; and (4) the PBGC.

Such a notice must include: (1) identifying information, including the name of the plan, the address and phone number of the plan administrator and the plan’s principal administrative officer, each plan sponsor’s employer identification number, and the plan identification number; (2) a statement as to whether the plan’s funded current liability percentage for the plan year to which the notice relates is at least 100 percent (and if not, a statement of the percentage); (3) a statement of the value of the plan’s assets, the amount of benefit payments, and the ratio of the assets to the payments for the plan year to which the notice relates; (4) a summary of the rules governing insolvent multiemployer plans, including the limitations on benefit payments and any potential benefit reductions and suspensions (and the potential effects of such limitations, reductions, and suspensions on the plan); (5) a general description of the benefits under the plan that are eligible to be guaranteed by the PBGC and the limitations of the guarantee and circumstances in which such limitations apply; and (6) any additional information the plan administrator elects to include to the extent it is not inconsistent with regulations prescribed by the Secretary of Labor.

¹¹⁴ ERISA sec. 101(d).

¹¹⁵ ERISA sec. 4011.

The annual funding notice must be provided no later than two months after the deadline (including extensions) for filing the plan's annual report for the plan year to which the notice relates (i.e., nine months after the end of the plan year unless the due date for the annual report is extended). The funding notice must be provided in a form and manner prescribed in regulations by the Secretary of Labor. Additionally, it must be written so as to be understood by the average plan participant and may be provided in written, electronic, or some other appropriate form to the extent that it is reasonably accessible to persons to whom the notice is required to be provided.

A plan administrator that fails to provide the required notice to a participant or beneficiary may be liable to the participant or beneficiary in the amount of up to \$100 a day from the time of the failure and for such other relief as a court may deem proper.

Explanation of Provision

The provision expands the annual funding notice requirement that applies under present law to multiemployer plans, so that it applies also to single-employer plans and, in the case of a single-employer plan, includes a summary of the PBGC rules governing plan termination. The provision also changes the information that must be provided in the notice and accelerates the time when the notice must be provided.

In addition to the information required under present law, an annual funding notice with respect to either a single-employer or multiemployer plan must include the following additional information, as of the end of the plan year to which the notice relates: (1) a statement of the number of participants who are retired or separated from service and receiving benefits, retired or separated participants who are entitled to future benefits, and active participants); (2) a statement setting forth the funding policy of the plan and the asset allocation of investments under the plan (expressed as percentages of total assets); (3) an explanation containing specific information of any plan amendment, scheduled benefit increase or reduction, or other known event taking effect in the current plan year and having a material effect on plan liabilities or assets for the year (as defined in regulations by the Secretary); and (4) a statement that a person may obtain a copy of the plan's annual report upon request, through the Department of Labor Internet website, or through an Intranet website maintained by the applicable plan sponsor.

In the case of a single-employer plan, the notice must provide: (1) a statement as to whether the plan's funding target attainment percentage (as defined under the minimum funding rules for single-employer plans) for the plan year to which the notice relates and the two preceding plan years, is at least 100 percent (and, if not, the actual percentages); (2) a statement of (a) the total assets (separately stating any funding standard carryover or prefunding balance) and the plan's liabilities for the plan year and the two preceding years, determined in the same manner as under the funding rules, and (b) the value of the plan's assets and liabilities as of the last day of the plan year to which the notice relates, determined using fair market value and the interest rate used in determining variable rate premiums; and (3) if applicable, a statement that each contributing sponsor, and each member of the sponsor's controlled group, was required to provide the information under section 4010 for the plan year to which the notice relates.

In the case of a multiemployer plan, the notice must provide: (1) a statement as to whether the plan's funded percentage (as defined under the minimum funding rules for

multiemployer plans) for the plan year to which the notice relates and the two preceding plan years, is at least 100 percent (and, if not, the actual percentages); (2) a statement of the value of the plan's assets and liabilities for the plan year to which the notice relates and the two preceding plan years; (3) whether the plan was in endangered or critical status and, if so, a summary of the plan's funding improvement or rehabilitation plan and a statement describing how a person can obtain a copy of the plan's funding improvement or rehabilitation plan and the actuarial or financial data that demonstrate any action taken by the plan toward fiscal improvement; and (4) a statement that the plan administrator will provide, on written request, a copy of the plan's annual report to any labor organization representing participants and beneficiaries and any employer that has an obligation to contribute to the plan.

The annual funding notice must be provided within 120 days after the end of the plan year to which it relates. In the case of a plan covering not more than 100 employees for the preceding year, the annual funding notice must be provided upon filing of the annual report with respect to the plan (i.e., within seven months after the end of the plan year unless the due date for the annual report is extended).

The Secretary of Labor is required to publish a model notice not later than one year after the date of enactment. In addition, the Secretary of Labor is given the authority to promulgate any interim final rules as appropriate to carry out the requirement that a model notice be published.

Under the provision, the annual funding notice includes the information provided in the notice required under present law in the case of a single-employer plan that is subject to PBGC variable rate premiums. Accordingly, that present-law notice requirement is repealed under the provision.

Effective Date

The provision is effective for plan years beginning after December 31, 2007, except that the repeal of the notice required under present law in the case of a single-employer plan that is subject to PBGC variable rate premiums is effective for plan years beginning after December 31, 2006. Under a transition rule, any requirement to report a plan's funding target attainment percentage or funded percentage for a plan year beginning before January 1, 2008, is met if (1) in the case of a plan year beginning in 2006, the plan's funded current liability percentage is reported, and (2) in the case of a plan year beginning in 2007, the funding target attainment percentage or funded percentage as determined using such methods of estimation as the Secretary of the Treasury may provide is reported.

B. Access to Multiemployer Pension Plan Information
(secs. 101, 204(h), and 502(c) of ERISA and sec. 4980F of the Code)

Present Law

Annual report

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation (“PBGC”). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

In the case of a defined benefit pension plan, the annual report must include an actuarial statement. The actuarial statement must include, for example, information as to the value of plan assets, the plan’s accrued and current liabilities, the plan’s actuarial cost method and actuarial assumptions, and plan contributions. The report must be signed by an actuary enrolled to practice before the IRS, Department of Labor and the PBGC.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date generally may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

Notice of significant reduction in benefit accruals

If an amendment to a defined benefit pension plan provides for a significant reduction in the rate of future benefit accrual, the plan administrator must furnish a written notice concerning the amendment. Notice may also be required if a plan amendment eliminates or reduces an early retirement benefit or retirement-type subsidy. The plan administrator is required to provide the notice to any participant or alternate payee whose rate of future benefit accrual may reasonably be expected to be significantly reduced by the plan amendment (and to any employee organization representing affected participants). The notice must be written in a manner calculated to be understood by the average plan participant and must provide sufficient information to allow recipients to understand the effect of the amendment. The plan administrator is generally required to provide the notice at least 45 days before the effective date of the plan amendment.

Explanation of Provision

Under the provision, a plan administrator of a multiemployer plan must, within 30 days of a written request, provide a plan participant or beneficiary, employee organization or employer that has an obligation to contribute to the plan with a copy of: (1) any periodic actuarial report (including any sensitivity testing) for any plan year that has been in the plan’s possession for at least 30 days; (2) a copy of any quarterly, semi-annual, or annual financial report prepared for the plan by any plan investment manager or advisor or other person who is a plan fiduciary that has been in the plan’s possession for at least 30 days; and (3) a copy of any application for an amortization extension filed with the Secretary of the Treasury. Any actuarial

report or financial report provided to a participant, beneficiary, or employer must not include any individually identifiable information regarding any participant, beneficiary, employee, fiduciary, or contributing employer, or reveal any proprietary information regarding the plan, any contributing employer, or any entity providing services to the plan. Regulations relating to the requirement to provide actuarial or financial reports on request must be issued within one year after the date of enactment.

In addition, the plan sponsor or administrator of a multiemployer plan must provide to any employer having an obligation to contribute to the plan, within 180 days of a written request, notice of: (1) the estimated amount that would be the employer's withdrawal liability with respect to the plan if the employer withdrew from the plan on the last day of the year preceding the date of the request; and (2) an explanation of how the estimated liability amount was determined, including the actuarial assumptions and methods used to determine the value of plan liabilities and assets, the data regarding employer contributions, unfunded vested benefits, annual changes in the plan's unfunded vested benefits, and the application of any relevant limitations on the estimated withdrawal liability. Regulations may permit a longer time than 180 days as may be necessary in the case of a plan that determines withdrawal liability using certain methods.

A person is not entitled to receive more than one copy of any actuary or financial report or more than one notice of withdrawal liability during any 12-month period. The plan administrator may make a reasonable charge to cover copying, mailing, and other costs of furnishing copies or notices, subject to a maximum amount that may be prescribed by regulations. Any information required to be provided under the provision may be provided in written, electronic, or other appropriate form to the extent such form is reasonably available to the persons to whom the information is required to be provided.

In the case of a failure to comply with these requirements, the Secretary of Labor may assess a civil penalty of up to \$1,000 per day for each failure to provide a notice.

Under the provision, notice of an amendment that provides for a significant reduction in the rate of future benefit accrual must be provided also to each employer that has an obligation to contribute to the plan.

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

**C. Additional Annual Reporting Requirements and
Electronic Display of Annual Report Information
(secs. 103 and 104 of ERISA)**

Present Law

Annual report

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation (“PBGC”). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

In the case of a defined benefit pension plan, the annual report must include an actuarial statement. The actuarial statement must include, for example, information as to the value of plan assets, the plan’s accrued and current liabilities, the plan’s actuarial cost method and actuarial assumptions, and plan contributions. The report must be signed by an actuary enrolled to practice before the IRS, Department of Labor and the PBGC.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date generally may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

Summary annual report

A participant must be provided with a copy of the full annual report on written request. In addition, the plan administrator must automatically provide participants with a summary of the annual report within two months after the due date of the annual report (i.e., by the end of the ninth month after the end of the plan year unless an extension applies). The summary annual report must include a statement whether contributions were made to keep the plan funded in accordance with minimum funding requirements, or whether contributions were not made and the amount of the deficit. The current value of plan assets is also required to be disclosed. If an extension applies for the Form 5500, the summary annual report must be provided within two months after the extended due date. A plan administrator who fails to provide a summary annual report to a participant within 30 days of the participant making a request for the report may be liable to the participant for a civil penalty of up to \$100 a day from the date of the failure.

Explanation of Provision

Annual report

The provision requires additional information to be provided in the annual report filed with respect to a defined benefit pension plan. In a case in which the liabilities under the plan as of the end of a plan year consist (in whole or in part) of liabilities under two or more other pension plans as of immediately before the plan year, the annual report must include the plan’s funded percentage as of the last day of the plan year and the funded percentage of each of such

other plans. Funded percentage is defined as: (1) in the case of a single-employer plan, the plan's funded target attainment percentage (as defined under the minimum funding rules for single-employer plans); and (2) in the case of a multiemployer plan, the plan's funded percentage (as defined under the minimum funding rules for multiemployer plans).

An annual report filed with respect to a multiemployer plan must include, as of the end of the plan year, the following additional information: (1) the number of employers obligated to contribute to the plan; (2) a list of the employers that contributed more than five percent of the total contributions to the plan during the plan year; (3) the number of participants on whose behalf no contributions were made by an employer as an employer of the participant for the plan year and two preceding years; (4) the ratio of the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during the plan year, to the number of participants under the plan on whose behalf no employer had an obligation to make an employer contribution during each of the two preceding plan years; (5) whether the plan received an amortization extension for the plan year and, if so, the amount by which it changed the minimum required contribution for the year, what minimum contribution would have been required without the extension, and the period of the extension; (6) whether the plan used the shortfall funding method and, if so, the amount by which it changed the minimum required contribution for the year, what minimum contribution would have been required without the use of this method, and the period for which the method is used; (7) whether the plan was in critical or endangered status for the plan year, and if so, a summary of any funding improvement or rehabilitation plan (or modification thereto) adopted during the plan year, and the funding percentage of the plan; (8) the number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against the withdrawn employers; (9) if the plan that has merged with another plan or if assets and liabilities have been transferred to the plan, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as prescribed by regulation.

The Secretary of Labor is required, not later than one year after the date of enactment, to publish guidance to assist multiemployer plans to identify and enumerate plan participants for whom there is no employer with an obligation to make an employer contribution under the plan and report such information in the annual report. The Secretary may provide rules as needed to apply this requirement with respect to contributions made on a basis other than hours worked, such as on the basis of units of production.

The actuarial statement filed with the annual return must include a statement explaining the actuarial assumptions and methods used in projecting future retirements and asset distributions under the plan.

Electronic display of annual report

Identification and basic plan information and actuarial information included in the annual report must be filed with the Secretary of Labor in an electronic format that accommodates display on the Internet (in accordance with regulations). The Secretary of Labor is to provide for

the display of such information, within 90 days after the filing of the annual report, on a website maintained by the Secretary of Labor on the Internet and other appropriate media. Such information is also required to be displayed on any Intranet website maintained by the plan sponsor (or by the plan administrator on behalf of the plan sponsor) in accordance with regulations.

Summary annual report

Under the provision, the requirement to provide a summary annual report to participants applies does not apply to defined benefit pension plans.¹¹⁶

Multiemployer plan summary report

The provision requires the plan administrator of a multiemployer plan to provide a report containing certain summary plan information to each employee organization and each employer with an obligation to contribute to the plan within 30 days after the due date of the plan's annual report. The report must contain: (1) a description of the contribution schedules and benefit formulas under the plan, and any modification to such schedules and formulas, during such plan year; (2) the number of employers obligated to contribute to the plan; (3) a list of the employers that contributed more than 5 percent of the total contributions to the plan during such plan year; (4) the number of participants under the plan on whose behalf no employer contributions have been made to the plan for such plan year and for each of the two preceding plan years; (5) whether the plan was in critical or endangered status for the plan year and, if so, a list of the actions taken by the plan to improve its funding status and a statement describing how to obtain a copy of the plan's improvement or rehabilitation plan, as appropriate, and the actuarial and financial data that demonstrate any action taken by the plan toward fiscal improvement; (6) the number of employers that withdrew from the plan during the preceding plan year and the aggregate amount of withdrawal liability assessed, or estimated to be assessed, against such withdrawn employers, as reported on the annual report for the plan year; (7) if the plan that has merged with another plan or if assets and liabilities have been transferred to the plan, the actuarial valuation of the assets and liabilities of each affected plan during the year preceding the effective date of the merger or transfer, based upon the most recent data available as of the day before the first day of the plan year, or other valuation method performed under standards and procedures as prescribed by regulation; (8) a description as to whether the plan sought or received an amortization extension or used the shortfall funding method for the plan year; and (9) notification of the right to obtain upon written request a copy of the annual report filed with respect to the plan, the summary annual report, the summary plan description, and the summary of any material modification of the plan, subject to a limitation of one copy of any such document in any 12-month period and any reasonable charge to cover copying, mailing, and other costs of furnishing the document. Nothing in this report requirement waives any other ERISA provision requiring plan administrators to provide, upon request, information to employers that have an obligation to contribute under the plan.

¹¹⁶ As discussed in Part A above, detailed information about a defined benefit pension plan must be provided to participants in an annual funding notice.

Effective Date

The provisions are effective for plan years beginning after December 31, 2007.

**D. Section 4010 Filings with the PBGC
(sec. 4010 of ERISA)**

Present Law

Present law provides that, in certain circumstances, the contributing sponsor of a single-employer plan defined benefit pension plan covered by the PBGC (and members of the contributing sponsor's controlled group) must provide certain information to the PBGC (referred to as "section 4010 reporting"). This information includes financial information with respect to the contributing sponsor (and controlled group members) and actuarial information with respect to single-employer plans maintained by the sponsor (and controlled group members).¹¹⁷ Section 4010 reporting is required if: (1) the aggregate unfunded vested benefits (determined using the interest rate used in determining variable-rate premiums) as of the end of the preceding plan year under all plans maintained by members of the controlled group exceed \$50 million (disregarding plans with no unfunded vested benefits); (2) the conditions for imposition of a lien (i.e., required contributions totaling more than \$1 million have not been made) have occurred with respect to an underfunded plan maintained by a member of the controlled group; or (3) minimum funding waivers in excess of \$1 million have been granted with respect to a plan maintained by any member of the controlled group and any portion of the waived amount is still outstanding. Information provided to the PBGC in accordance with these requirements is not available to the public.

The PBGC may assess a penalty for a failure to provide the required information in the amount of up to \$1,000 a day for each day the failure continues.¹¹⁸

Explanation of Provision

Under the provision, the requirement of section 4010 reporting applicable under present law if aggregate unfunded vested benefits exceed \$50 million is replaced with a requirement of section 4010 reporting if: (1) the funding target attainment percentage at the end of the preceding plan year of a plan maintained by a contributing sponsor or any member of its controlled group is less than 80 percent. It is intended that the PBGC may waive the requirement in appropriate circumstances, such as in the case of small plans.

The provision also requires the information provided to the PBGC to include the following: (1) the amount of benefit liabilities under the plan determined using the assumptions used by the PBGC in determining liabilities; (2) the funding target of the plan determined as if the plan has been in at-risk status for at least 5 plan years; and (3) the funding target attainment percentage of the plan.

The value of plan assets, a plan's funding target, a plan's funding target attainment percentage, and at-risk status are determined under the provision relating to funding rules

¹¹⁷ ERISA sec. 4010.

¹¹⁸ ERISA sec. 4071.

applicable to single-employer plans under the provision. Thus, a plan's funding target for a plan year is the present value of the benefits earned or accrued under the plan as of the beginning of the plan year. A plan's "funding target attainment percentage" means the ratio, expressed as a percentage, that the value of the plan's assets (reduced by any funding standard carryover balance and prefunding balance) bears to the plan's funding target for the year (determined without regard to the special assumptions that apply to at-risk plans). A plan is in at-risk status for a plan year if the plan's funding target attainment percentage for the preceding year was less than (1) 80 percent, determined without regard to the special at-risk assumptions, and (2) 70 percent, determined using the special at-risk assumptions.

The provision requires the PBGC to provide the Senate Committees on Health, Education, Labor, and Pensions and Finance and the House Committees on Education and the Workforce and Ways and Means with a summary report in the aggregate of the information submitted to the PBGC under section 4010.

Effective Date

The provision is effective for filings for years beginning after December 31, 2007.

**E. Disclosure of Plan Termination Information to Plan Participants
(secs. 4041 and 4042 of ERISA)**

Present Law

In the case of a single-employer defined benefit pension plan covered under the PBGC insurance program, the plan sponsor may voluntarily terminate the plan in a standard termination or a distress termination.¹¹⁹ A standard termination is permitted only if plan assets are sufficient to cover benefit liabilities.

If assets in a defined benefit plan are not sufficient to cover benefit liabilities, the plan sponsor may not terminate the plan unless the plan sponsor (and members of the plan sponsor's controlled group) meets one of four criteria of financial distress. The four criteria for a distress termination are: (1) the plan sponsor, and every member of the controlled group of which the sponsor is a member, is being liquidated in bankruptcy or any similar Federal law or other similar State insolvency proceedings; (2) the plan sponsor and every member of the sponsor's controlled group is being reorganized in bankruptcy or similar State proceeding; (3) the PBGC determines that termination is necessary to allow the plan sponsor to pay its debts when due; or (4) the PBGC determines that termination is necessary to avoid unreasonably burdensome pension costs caused solely by a decline in the plan sponsor's work force.

In order for a plan sponsor to terminate a plan, the plan administrator must provide each affected party with advance written notice of the intent to terminate at least 60 days before the proposed termination date. Additional information must be included as required by the PBGC. For this purpose, an affected party is: (1) a plan participant; (2) a beneficiary of a deceased participant or an alternate payee under a qualified domestic relations order; (3) any employee organization representing plan participants; and (4) the PBGC (except in the case of a standard termination). In the case of a proposed distress termination, as soon as practicable after providing notice, the plan administrator must provide the PBGC with certain information, including information necessary for the PBGC to determine whether any of the criteria for a distress termination is met.

The PBGC may institute proceedings to terminate a single-employer plan if it determines that the plan in question: (1) has not met the minimum funding standards; (2) will be unable to pay benefits when due; (3) has a substantial owner who has received a distribution greater than \$10,000 (other than by reason of death) while the plan has unfunded vested benefits; or (4) may reasonably be expected to increase the PBGC's long-run loss with respect to the plan unreasonably if the plan is not terminated. The PBGC must institute proceedings to terminate a plan if the plan is unable to pay benefits that are currently due.

If the PBGC determines that the requirements for an involuntary plan termination are met, it must provide notice to the plan.

¹¹⁹ The PBGC may not proceed with a voluntary termination if the termination would violate an existing collective bargaining agreement.

Explanation of Provision

The provision revises the rules applicable in the case of a distress termination to require a plan administrator to provide an affected party with any information provided to the PBGC in connection with the proposed plan termination. The plan administrator must provide the information not later than 15 days after: (1) the receipt of a request for the information from the affected party; or (2) the provision of new information to the PBGC relating to a previous request.

The provision also requires the plan sponsor or plan administrator of a plan that has received notice from the PBGC of a determination that the plan should be involuntarily terminated to provide an affected party with any information provided to the PBGC in connection with the plan termination. In addition, the PBGC is required to provide a copy of the administrative record, including the trusteeship decision record in connection with a plan termination. The plan sponsor, plan administrator, or PBGC must provide the required information not later than 15 days after: (1) the receipt of a request for the information from the affected party; or (2) in the case of information provided to the PBGC, the provision of new information to the PBGC relating to a previous request.

The PBGC may prescribe the form and manner in which information is to be provided, which is to include delivery in written, electronic, or other appropriate form to the extent such form is reasonably accessible to individuals to whom the information is required to be provided. A plan administrator or plan sponsor may charge a reasonable fee for any information provided under this subparagraph in other than electronic form.

A plan administrator or plan sponsor may not provide the relevant information in a form that includes any information that may directly or indirectly be associated with, or otherwise identify, an individual participant or beneficiary. In addition, a court may limit disclosure of confidential information (as described under the Freedom of Information Act) to any authorized representative of the participants or beneficiaries that agrees to ensure the confidentiality of such information. For this purposes, an authorized representative means any employee organization representing participants in the pension plan.

Effective Date

The provision generally applies with respect to any plan termination, with respect to which the notice of intent to terminate, or notice that the PBGC has determined that the requirements for an involuntary plan termination are met, occurs after the date of enactment. Under a transition rule, if notice under the provision would otherwise be required before the 90th day after the date of enactment, such notice is not required to be provided until the 90th day.

**F. Notice of Freedom to Divest Employer Securities
(new sec. 101(m) of ERISA)**

Present Law

Under ERISA, a plan administrator is required to furnish participants with certain notices and information about the plan. This information includes, for example, a summary plan description that includes certain information, including administrative information about the plan, the plan's requirements as to eligibility for participation and benefits, the plan's vesting provisions, and the procedures for claiming benefits under the plan. Under ERISA, if a plan administrator fails or refuses to furnish to a participant information required to be provided to the participant within 30 days of the participant's written request, the participant generally 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.

Explanation of Provision

The provision requires a new notice in connection with the right of an applicable individual to divest his or her account under an applicable defined contribution plan of employer securities, as required under the provision of the provision relating to diversification rights with respect to amounts invested in employer securities. Not later than 30 days before the first date on which an applicable individual is eligible to exercise such right with respect to any type of contribution, the administrator of the plan must provide the individual with a notice setting forth such right and describing the importance of diversifying the investment of retirement account assets. Under the diversification provision, an applicable individual's right to divest his or her account of employer securities attributable to elective deferrals and employee after-tax contributions and the right to divest his or her account of employer securities attributable to other contributions (i.e., nonelective employer contributions and employer matching contributions) may become exercisable at different times. Thus, to the extent the applicable individual is first eligible to exercise such rights at different times, separate notices are required.

The notice must be written in a manner calculated to be understood by the average plan participant and may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the applicable individual. The Secretary of Treasury has regulatory authority over the required notice and is directed to prescribe a model notice to be used for this purpose within 180 days of the date of enactment of the provision. It is expected that the Secretary of Treasury will consult with the Secretary of Labor on the description of the importance of diversifying the investment of retirement account assets. In addition, it is intended that the Secretary of Treasury will prescribe rules to enable the notice to be provided at reduced administrative expense, such as allowing the notice to be provided with the summary plan description, with a reminder of these rights within a reasonable period before they become exercisable.

In the case of a failure to provide a required notice of diversification rights, the Secretary of Labor may assess a civil penalty against the plan administrator of up to \$100 a day from the date of the failure. For this purpose, each violation with respect to any single applicable individual is treated as a separate violation.

Effective Date

The provision generally applies to plan years beginning after December 31, 2006. Under a transition rule, if notice would otherwise be required to be provided before 90 days after the date of enactment, notice is not required until 90 days after the date of enactment.

G. Periodic Pension Benefit Statements (secs. 105(a) and 502(c)(1) of ERISA)

Present Law

ERISA provides that the administrator of a defined contribution or defined benefit pension plan must furnish a benefit statement to any participant or beneficiary who makes a written request for such a statement. 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 a plan administrator fails or refuses to furnish a benefit statement to a participant or beneficiary within 30 days of a 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.

Explanation of Provision

In general

The provision revises the benefit statement requirements under ERISA. The new requirements depend in part on the type of plan and the individual to whom the statement is provided. The benefit statement requirements do not apply to a one-participant retirement plan.¹²⁰

A benefit statement is required to indicate, on the basis of the latest available information: (1) the total benefits accrued; (2) the vested accrued benefit or the earliest date on which the accrued benefit will become vested; and (3) an explanation of any permitted disparity or floor-offset arrangement that may be applied in determining accrued benefits under the plan.¹²¹ With respect to information on vested benefits, the Secretary of Labor is required to provide that the requirements are met if, at least annually, the plan: (1) updates the information on vested benefits that is provided in the benefit statement; or (2) provides in a separate statement information as is necessary to enable participants and beneficiaries to determine their vested benefits.

If a plan administrator fails to provide a required benefit statement to a participant or beneficiary, the participant or beneficiary may bring a civil action to recover from the plan

¹²⁰ A one-participant retirement plan is defined as under the provision of ERISA that requires advance notice of a blackout period to be provided to participants and beneficiaries affected by the blackout period, as discussed in Part H below.

¹²¹ Under the permitted disparity rules, contributions or benefits may be provided at a higher rate with respect to compensation above a specified level and at a lower rate with respect to compensation up to the specified level. In addition, benefits under a defined benefit plan may be offset by a portion of a participant's expected social security benefits. Under a floor-offset arrangement, benefits under a defined benefit pension plan are reduced by benefits under a defined contribution plan.

administrator \$100 a day, within the court's discretion, or other relief that the court deems proper.

Requirements for defined contribution plans

The administrator of a defined contribution plan is required to provide a benefit statement (1) to a participant or beneficiary who has the right to direct the investment of the assets in his or her account, at least quarterly, (2) to any other participant or other beneficiary who has his or her own account under the plan, at least annually, and (3) to other beneficiaries, upon written request, but limited to one request during any 12-month period.

A benefit statement provided with respect to a defined contribution plan must include the value of each investment to which assets in the individual's account are allocated (determined as of the plan's most recent valuation date), including the value of any assets held in the form of employer securities (without regard to whether the securities were contributed by the employer or acquired at the direction of the individual). A quarterly benefit statement provided to a participant or beneficiary who has the right to direct investments must also provide: (1) an explanation of any limitations or restrictions on any right of the individual to direct an investment; (2) an explanation, written in a manner calculated to be understood by the average plan participant, of the importance, for the long-term retirement security of participants and beneficiaries, of a well-balanced and diversified investment portfolio, including a statement of the risk that holding more than 20 percent of a portfolio in the security of one entity (such as employer securities) may not be adequately diversified; and (3) a notice directing the participant or beneficiary to the Internet website of the Department of Labor for sources of information on individual investing and diversification.

Requirements for defined benefit plans

The administrator of a defined benefit plan is required either: (1) to furnish a benefit statement at least once every three years to each participant who has a vested accrued benefit under the plan and who is employed by the employer at the 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 can obtain it. The Secretary of Labor is authorized to provide that years in which no employee or former employee benefits under the plan need not be taken into account in determining the three-year period. It is intended that the annual notice of the availability of a benefit statement may 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 pension plan is also required to furnish a benefit statement to a participant or beneficiary upon written request, limited to one request during any 12-month period.

In the case of a statement provided to a participant with respect to a defined benefit plan (other than at the participant's request), information may be based on reasonable estimates determined under regulations prescribed by the Secretary of Labor in consultation with the Pension Benefit Guaranty Corporation.

Form of benefit statement

A benefit statement must be written in a manner calculated to be understood by the average plan participant. It may be delivered in written, electronic, or other appropriate form to the extent such form is reasonably accessible to the recipient. For example, regulations could permit current benefit statements to be provided on a continuous basis through a secure plan website for a participant or beneficiary who has access to the website.

The Secretary of Labor is directed, within one year after the date of enactment, to develop one or more model benefit statements that may be used by plan administrators in complying with the benefit statement requirements. The use of the model statement is optional. It is intended that the model statement include items such as the amount of vested 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 vested 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. The Secretary of Labor is also given the authority to promulgate any interim final rules as determined appropriate to carry out the benefit statement requirements.

Effective Date

The provision is generally effective for plan years beginning after December 31, 2006. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2007, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2008.

H. Notice to Participants or Beneficiaries of Blackout Periods (sec. 101(i) of ERISA)

Present Law

In general

The Sarbanes-Oxley Act of 2002¹²² amended ERISA to require that the plan administrator of an individual account plan¹²³ provide advance notice of a blackout period (a “blackout notice”) to plan participants and beneficiaries to whom the blackout period applies.¹²⁴ Generally, notice must be provided at least 30 days before the beginning of the blackout period. In the case of a blackout period that applies with respect to employer securities, the plan administrator must also provide timely notice of the blackout period to the employer (or the affiliate of the employer that issued the securities, if applicable).

The blackout notice requirement does not apply to a one-participant retirement plan, which is defined as a plan that (1) on the first day of the plan year, covered only the employer (and the employer’s spouse) and the employer owns the entire business (whether or not incorporated) or covers only one or more partners (and their spouses) in a business partnership (including partners in an S or C corporation as defined in section 1361(a) of the Code), (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.¹²⁵

Definition of blackout period

A blackout period is any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities

¹²² Pub. L. No. 107-204 (2002).

¹²³ An “individual account plan” is the term generally used under ERISA for a defined contribution plan.

¹²⁴ ERISA sec. 101(i), as enacted by section 306(b) of the Sarbanes-Oxley Act of 2002. Under section 306(a), a director or executive officer of a publicly-traded corporation is prohibited from trading in employer stock during blackout periods in certain circumstances. Section 306 is effective 180 days after enactment.

¹²⁵ Governmental plans and church plans are exempt from ERISA. Accordingly, the blackout notice requirement does not apply to these plans.

laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary under a qualified domestic relations order.

Timing of notice

Notice of a blackout period is generally required at least 30 days before the beginning of the period. The 30-day notice requirement does not apply if (1) deferral of the blackout period would violate the fiduciary duty requirements of ERISA and a plan fiduciary so determines in writing, or (2) the inability to provide the 30-day advance notice is due to events that were unforeseeable or circumstances beyond the reasonable control of the plan administrator and a plan fiduciary so determines in writing. In those cases, notice must be provided as soon as reasonably practicable under the circumstances unless notice in advance of the termination of the blackout period is impracticable.

Another exception to the 30-day period applies in the case of a blackout period that applies only to one or more participants or beneficiaries in connection with a merger, acquisition, divestiture, or similar transaction involving the plan or the employer and that occurs solely in connection with becoming or ceasing to be a participant or beneficiary under the plan by reason of the merger, acquisition, divestiture, or similar transaction. Under the exception, the blackout notice requirement is treated as met if notice is provided to the participants or beneficiaries to whom the blackout period applies as soon as reasonably practicable.

The Secretary of Labor may provide additional exceptions to the notice requirement that the Secretary determines are in the interests of participants and beneficiaries.

Form and content of notice

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

Notices provided in connection with a blackout period (or changes thereto) must be provided in writing and may be delivered in electronic or other form to the extent that the form is reasonably accessible to the recipient. The Secretary of Labor is required to issue guidance regarding the notice requirement and a model blackout notice.

Penalty for failure to provide notice

In the case of a failure to provide notice of a blackout period, the Secretary of Labor may assess a civil penalty against a plan administrator of up to \$100 per day for each failure to provide a blackout notice. For this purpose, each violation with respect to a single participant or beneficiary is treated as a separate violation.

Explanation of Provision

The provision modifies the definition of a one-participant retirement plan to be consistent with Department of Labor regulations under which certain business owners and their spouses are not treated as employees.¹²⁶ As modified, a one-participant retirement plan is a plan that: (1) on the first day of the plan year, either covered only one individual (or the individual and his or her spouse) and the individual owned 100 percent of the plan sponsor, whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; and (2) does not cover a business that leases employees.

Effective Date

The provision is effective as if included in section 306 of the Sarbanes-Oxley Act of 2002.

¹²⁶ 29 C.F.R. sec. 2510.3-3(c) (2006).

TITLE VI: INVESTMENT ADVICE, PROHIBITED TRANSACTIONS, AND FIDUCIARY RULES

A. Investment Advice (sec. 408 of ERISA and sec. 4975 of the Code)

Present Law

ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person (referred to as a “party in interest” under ERISA).¹²⁷ Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities, as well as individual retirement accounts and annuities (“IRAs”), health savings accounts (“HSAs”), Archer MSAs, and Coverdell education savings accounts.¹²⁸

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

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

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

¹²⁷ ERISA sec. 406; Code sec. 4975.

¹²⁸ The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans.

transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved.

Explanation of Provision

In general

The provision adds a new category of prohibited transaction exemption under ERISA and the Code in connection with the provision of investment advice through an "eligible investment advice arrangement" to participants and beneficiaries of a defined contribution plan who direct the investment of their accounts under the plan and to beneficiaries of IRAs.¹²⁹ If the requirements under the provision are met, the following are exempt from prohibited transaction treatment: (1) the provision of investment advice; (2) an investment transaction (i.e., a sale, acquisition, or holding of a security or other property) pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. The prohibited transaction exemptions provided under the provision do not in any manner alter existing individual or class exemptions provided by statute or administrative action.

The provision also directs the Secretary of Labor, in consultation with the Secretary of the Treasury, to determine, based on certain information to be solicited by the Secretary of Labor, whether there is any computer model investment advice program that meets the requirements of the provision and may be used by IRAs. The determination is to be made by December 31, 2007. If the Secretary of Labor determines there is such a program, the exemptions described above apply in connection with the use of the program with respect to IRA beneficiaries. If the Secretary of Labor determines that there is not such a program, such Secretary is directed to grant a class exemption from prohibited transaction treatment (as discussed below) for the provision of investment advice, investment transactions pursuant to such advice, and related fees to beneficiaries of such arrangements.

Eligible investment advice arrangements

In general

The exemptions provided under the provision apply in connection with the provision of investment advice by a fiduciary adviser under an eligible investment advice arrangement. An eligible investment advice arrangement is an arrangement (1) meeting certain requirements (discussed below) and (2) which either (a) provides that any fees (including any commission or compensation) received by the fiduciary adviser for investment advice or with respect to an investment transaction with respect to plan assets do not vary depending on the basis of any investment option selected, or (b) uses a computer model under an investment advice program as described below in connection with the provision of investment advice to a participant or beneficiary. In the case of an eligible investment advice arrangement with respect to a defined

¹²⁹ The portions of the provision relating to IRAs apply to HSAs, Archer MSAs, and Coverdell education savings accounts. References here to IRAs include such other arrangements as well.

contribution plan, the arrangement must be expressly authorized by a plan fiduciary other than (1) the person offering the investment advice program, (2) any person providing investment options under the plan, or (3) any affiliate of (1) or (2).

Investment advice program using computer model

If an eligible investment advice arrangement provides investment advice pursuant to a computer model, the model must (1) apply generally accepted investment theories that take into account the historic returns of different asset classes over defined periods of time, (2) use relevant information about the participant or beneficiary, (3) use prescribed objective criteria to provide asset allocation portfolios comprised of investment options under the plan, (4) operate in a manner that is not biased in favor of any investment options offered by the fiduciary adviser or related person, and (5) take into account all the investment options under the plan in specifying how a participant's or beneficiary's account should be invested without inappropriate weighting of any investment option. An eligible investment expert must certify, before the model is used and in accordance with rules prescribed by the Secretary, that the model meets these requirements. The certification must be renewed if there are material changes to the model as determined under regulations. For this purpose, an eligible investment expert is a person who meets requirements prescribed by the Secretary and who does not bear any material affiliation or contractual relationship with any investment adviser or related person.

In addition, if a computer model is used, the only investment advice that may be provided under the arrangement is the advice generated by the computer model, and any investment transaction pursuant the advice must occur solely at the direction of the participant or beneficiary. This requirement does not preclude the participant or beneficiary from requesting other investment advice, but only if the request has not been solicited by any person connected with carrying out the investment advice arrangement.

Audit requirements

In the case of an eligible investment advice arrangement with respect to a defined contribution plan, an annual audit of the arrangement for compliance with applicable requirements must be conducted by an independent auditor (i.e., unrelated to the person offering the investment advice arrangement or any person providing investment options under the plan) who has appropriate technical training or experience and proficiency and who so represents in writing. The auditor must issue a report of the audit results to the fiduciary that authorized use of the arrangement. In the case of an eligible investment advice arrangement with respect to IRAs, an audit is required at such times and in such manner as prescribed by the Secretary of Labor.

Notice requirements

Before the initial provision of investment advice, the fiduciary adviser must provide written notice (which may be in electronic form) containing various information to the recipient of the advice, including information relating to: (1) the role of any related party in the development of the investment advice program or the selection of investment options under the plan; (2) past performance and rates of return for each investment option offered under the plan; (3) any fees or other compensation to be received by the fiduciary adviser or affiliate; (4) any

material affiliation or contractual relationship of the fiduciary adviser or affiliates in the security or other property involved in the investment transaction; (5) the manner and under what circumstances any participant or beneficiary information will be used or disclosed; (6) the types of services provided by the fiduciary adviser in connection with the provision of investment advice; (7) the adviser's status as a fiduciary of the plan in connection with the provision of the advice; and (8) the ability of the recipient of the advice separately to arrange for the provision of advice by another adviser that could have no material affiliation with and receive no fees or other compensation in connection with the security or other property. This information must be maintained in accurate form and must be provided to the recipient of the investment advice, without charge, on an annual basis, on request, or in the case of any material change.

Any notification must be written in a clear and conspicuous manner, calculated to be understood by the average plan participant, and sufficiently accurate and comprehensive so as to reasonably apprise participants and beneficiaries of the required information. The Secretary is directed to issue a model form for the disclosure of fees and other compensation as required by the provision. The fiduciary adviser must maintain for at least six years any records necessary for determining whether the requirements for the prohibited transaction exemption were met. A prohibited transaction will not be considered to have occurred solely because records were lost or destroyed before the end of six years due to circumstances beyond the adviser's control.

Other requirements

In order for the exemption to apply, the following additional requirements must be satisfied: (1) the fiduciary adviser must provide disclosures applicable under securities laws; (2) an investment transaction must occur solely at the direction of the recipient of the advice; (3) compensation received by the fiduciary adviser or affiliates in connection with an investment transaction must be reasonable; and (4) the terms of the investment transaction must be at least as favorable to the plan as an arm's length transaction would be.

Fiduciary adviser

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

representative” means a person described in section 3(a)(18) of the Securities Exchange Act of 1934 or a person described in section 202(a)(17) of the Investment Advisers Act of 1940.

Fiduciary rules

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

The provision does not exempt the employer or a plan fiduciary from fiduciary responsibility under ERISA for the prudent selection and periodic review of a fiduciary adviser with whom the employer or plan fiduciary has arranged for the provision of investment advice. The employer or plan fiduciary does not have the duty to monitor the specific investment advice given by a fiduciary adviser. The provision also provides that nothing in the fiduciary responsibility provisions of ERISA is to be construed to preclude the use of plan assets to pay for reasonable expenses in providing investment advice.

Study and determination by the Secretary of Labor; class exemption

Under the provision, the Secretary of Labor must determine, in consultation with the Secretary of the Treasury, whether there is any computer model investment advice program that can be used by IRAs and that meets the requirements of the provision. The determination is to be made on the basis of information to be solicited by the Secretary of Labor as described below. Under the provision, a computer model investment advice program must (1) use relevant information about the beneficiary, (2) take into account the full range of investments, including equities and bonds, in determining the options for the investment portfolio of the beneficiary, and (3) allow the account beneficiary, in directing the investment of assets, sufficient flexibility in obtaining advice to evaluate and select options. The Secretary of Labor must report the results of this determination to the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor, and Pensions no later than December 31, 2007.

As soon as practicable after the date of enactment, the Secretary of Labor, in consultation with the Secretary of the Treasury, must solicit information as to the feasibility of the application of computer model investment advice programs for IRAs, including from (1) at least the top 50 trustees of IRAs, determined on the basis of assets held by such trustees, and (2) other persons offering such programs based on nonproprietary products. The information solicited by the Secretary of Labor from such trustees and other persons is to include information on their computer modeling capabilities with respect to the current year and the preceding year, including their capabilities for investment accounts they maintain. If a person from whom the Secretary of

Labor solicits information does not provide such information within 60 days after the solicitation, the person is not entitled to use any class exemption granted by the Secretary of Labor as required under the provision (as discussed below) unless such failure is due to reasonable cause and not willful neglect.

The exemptions provided under the provision with respect to an eligible investment advice arrangement involving a computer model do not apply to IRAs. If the Secretary of Labor determines that there is a computer model investment advice program that can be used by IRAs, the exemptions provided under the provision with respect to an eligible investment advice arrangement involving a computer model can apply to IRAs.

If, as a result of the study of this issue as directed by the provision, the Secretary of Labor determines that there is not such a program, the Secretary of Labor must grant a class exemption from prohibited transaction treatment for (1) the provision of investment advice by a fiduciary adviser to beneficiaries of IRAs; (2) investment transactions pursuant to the advice; and (3) the direct or indirect receipt of fees or other compensation in connection with the provision of the advice or an investment transaction pursuant to the advice. Application of the exemptions are to be subject to conditions as are set forth in the class exemption and as are (1) in the interests of the IRA and its beneficiary and protective of the rights of the beneficiary, and (2) necessary to ensure the requirements of the applicable exemptions and the investment advice provided utilizes prescribed objective criteria to provide asset allocation portfolios comprised of securities or other property available as investments under the IRA. Such conditions could require that the fiduciary adviser providing the advice (1) adopt written policies and procedures that ensure the advice provided is not biased in favor of investments offered by the fiduciary adviser or a related person, and (2) appoint an individual responsible for annually reviewing the advice provided to determine that the advice is provided in accordance with the policies and procedures in (1).

If the Secretary of Labor later determines that there is any computer model investment advice program that can be used by IRAs, the class exemption ceases to apply after the later of (1) the date two years after the Secretary's later determination, or (2) the date three years after the date the exemption first took effect.

Any person may request the Secretary of Labor to make a determination with respect to any computer model investment advice program as to whether it can be used by IRAs, and the Secretary must make such determination within 90 days of the request. If the Secretary determines that the program cannot be so used, within 10 days of the determination, the Secretary must notify the House Committees on Ways and Means and Education and the Workforce and the Senate Committees on Finance and Health, Education, Labor, and Pensions thereof and the reasons for the determination.

Effective Date

The provisions are effective with respect to investment advice provided after December 31, 2006. The provision relating to the study by the Secretary of Labor is effective on the date of enactment.

B. Prohibited Transaction Rules Relating to Financial Investments
(secs. 408, 412(a), and 502(i) and new sec. 3(42) of ERISA,
and sec. 4975 of the Code)

1. Exemption for block trading

Present Law

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.¹³⁰ Present law does not provide a statutory prohibited transaction exemption for block trades. For purposes of the prohibited transaction rules, a fiduciary means any person who (1) exercises any authority or control respecting management or disposition of the plan's assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

Explanation of Provision

The provision provides prohibited transaction exemptions under ERISA and the Code for a purchase or sale of securities or other property (as determined by the Secretary of Labor) between a plan and a disqualified person (other than a fiduciary) involving a block trade if: (1) the transaction involves a block trade; (2) at the time of the transaction, the interest of the plan (together with the interests of any other plans maintained by the same plan sponsor) does not exceed 10 percent of the aggregate size of the block trade; (3) the terms of the transaction, including the price, are at least as favorable to the plan as an arm's length transaction with an unrelated party; and (4) the compensation associated with the transaction must be no greater than the compensation associated with an arm's length transaction with an unrelated party. For purposes of the provision, block trade is defined as any trade of at least 10,000 shares or with a market value of at least \$200,000 that will be allocated across two or more unrelated client accounts of a fiduciary. Examples of property other than securities that the Secretary of labor may apply the exemption to include (but are not limited to) future contracts and currency.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

¹³⁰ In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

2. Bonding relief

Present Law

Subject to certain exceptions, ERISA requires a plan fiduciary and any person handling plan assets to be bonded, generally in an amount between \$1,000 and \$500,000. An exception to the bonding requirement generally applies for a fiduciary (or a director, officer, or employee of the fiduciary) that is a corporation authorized to exercise trust powers or conduct an insurance business if the corporation is subject to supervision or examination by Federal or State regulators and meets certain financial requirements.

Explanation of Provision

The provision provides an exception to the ERISA bonding requirement for an entity registered as a broker or a dealer under the Securities Exchange Act of 1934 if the broker or dealer is subject to the fidelity bond requirements of a self-regulatory organization (within the meaning of the Securities Exchange Act of 1934).

Effective Date

The provision is effective for plan years beginning after the date of enactment.

3. Exemption for electronic communication network

Present Law

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.¹³¹ Present law does not provide a statutory prohibited transaction exemption for transactions made through an electronic communication network, but such transactions may be permitted if the parties are not known to each other (a “blind” transaction).

Explanation of Provision

The provision provides a prohibited transaction exemption under ERISA and the Code for a transaction involving the purchase or sale of securities (or other property as determined under regulations) between a plan and a party in interest if: (1) the transaction is executed through an electronic communication network, alternative trading system, or similar execution system or trading venue that is subject to regulation and oversight by (a) the applicable Federal regulating entity or (b) a foreign regulatory entity as the Secretary may determine under regulations; (2) either (a) neither the execution system nor the parties to the transaction take into account the identity of the parties in the execution of trades, or (b) the transaction is effected

¹³¹ In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

under rules designed to match purchases and sales at the best price available through the execution system in accordance with applicable rules of the SEC or other relevant governmental authority; (3) the price and compensation associated with the purchase and sale are not greater than an arm's length transaction with an unrelated party; (4) if the disqualified person has an ownership interest in the system or venue, the system or venue has been authorized by the plan sponsor or other independent fiduciary for this type of transaction; and (5) not less than 30 days before the first transaction of this type executed through any such system or venue, a plan fiduciary is provided written notice of the execution of the transaction through the system or venue.

Examples of other property for purposes of the exemption include (but are not limited to) futures contracts and currency.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

4. Exemption for service providers

Present Law

Certain transactions are exempt from prohibited transaction treatment if made for adequate consideration. For this purpose, adequate consideration means: (1) in the case of a security for which there is a generally recognized market, either the price of the security prevailing on a national securities exchange registered under the Securities Exchange Act of 1934, or, if the security is not traded on such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any disqualified person; and (2) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a trustee or named fiduciary pursuant to the terms of the plan and in accordance with regulations.¹³²

Explanation of Provision

The provision provides a prohibited transaction exemption under ERISA for certain transactions (such as sales of property, loans, and transfers or use of plan assets) between a plan and a person that is a party in interest solely by reason of providing services (or solely by reason of having certain relationships with a service provider), but only if, in connection with the transaction, the plan receives no less, nor pays no more, than adequate consideration. For this purpose, adequate consideration means: (1) in the case of a security for which there is a generally recognized market, the price of the security prevailing on a national securities exchange registered under the Securities Exchange Act of 1934, taking into account factors such as the size of the transaction and marketability of the security, or, if the security is not traded on

¹³² ERISA sec. 3(18).

such a national securities exchange, a price not less favorable to the plan than the offering price for the security as established by the current bid and asked prices quoted by persons independent of the issuer and of any disqualified person, taking into account factors such as the size of the transaction and marketability of the security; and (2) in the case of an asset other than a security for which there is a generally recognized market, the fair market value of the asset as determined in good faith by a fiduciary or named fiduciaries in accordance with regulations. The exemption does not apply to a fiduciary (or an affiliate) who has or exercises any discretionary authority or control with respect to the investment of the assets involved in the transaction or provides investment advice with respect to the assets.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

5. Relief for foreign exchange transactions

Present Law

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.¹³³ Present law does not provide a statutory prohibited transaction exemption for foreign exchange transactions.

Explanation of Provision

The provision provides a prohibited transaction exemption under ERISA and the Code for foreign exchange transactions between a bank or broker-dealer (or an affiliate of either) and a plan in connection with the sale, purchase, or holding of securities or other investment assets (other than a foreign exchange transaction unrelated to any other investment in securities or other investment assets) if: (1) at the time the foreign exchange transaction is entered into, the terms of the transaction are not less favorable to the plan than the terms generally available in comparable arm's length foreign exchange transactions between unrelated parties or the terms afforded by the bank or the broker-dealer (or any affiliate thereof) in comparable arm's-length foreign exchange transactions involving unrelated parties; (2) the exchange rate used for a particular foreign exchange transaction may not deviate by more than three percent from the interbank bid and asked rates at the time of the transaction for transactions of comparable size and maturity as displayed on an independent service that reports rates of exchange in the foreign currency market for such currency; and (3) the bank, broker-dealer (and any affiliate of either) does not have investment discretion or provide investment advice with respect to the transaction.

¹³³ In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

6. Definition of plan asset vehicle

Present Law

Under ERISA regulations, applicable also for purposes of the prohibited transaction rules of the Code, when a plan holds a non-publicly-traded equity interest in an entity, the assets of the entity may be considered plan assets in certain circumstances unless equity participation in the entity by benefit plan investors is not significant.¹³⁴ In general, such equity participation is significant if, immediately after the most recent acquisition of any equity interest in the entity, 25 percent or more of the value of any class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors, defined as (1) employer-sponsored plans (including those exempt from ERISA, such as governmental plans), (2) other arrangements, such as IRAs, that are subject only to the prohibited transaction rules of the Code, and (3) any entity whose assets are plan assets by reason of a plan's investment in the entity.¹³⁵ In that case, unless an exception applies, plan assets include the plan's equity interest in the entity and an undivided interest in each of the underlying assets of the entity.

Explanation of Provision

Under the provision, the term "plan assets" means plan assets as defined under regulations prescribed by the Secretary of Labor. Under the regulations, the assets of any entity are not to be treated as plan assets if, immediately after the most recent acquisition of any equity interest in the entity, less than 25 percent of the total value of each class of equity interest in the entity (disregarding certain interests) is held by benefit plan investors. For this purpose, an entity is considered to hold plan assets only to the extent of the percentage of the equity interest held by benefit plan investors, which means an employee benefit plan subject to the fiduciary rules of ERISA, any plan to which the prohibited transaction rules of the Code applies, and any entity whose underlying assets include plan assets by reason of a plan's investment in such entity.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

¹³⁴ 29 C.F.R. sec. 2510.3-101(a) (2005). As a result, a person who exercises authority or control respecting management or disposition of the assets of the entity or renders investment advice with respect to the assets for a fee (direct or indirect) is a plan fiduciary.

¹³⁵ 29 C.F.R. sec. 2510.3-101(f) (2005).

7. Exemption for cross trading

Present Law

Present law provides statutory exemptions from the prohibited transaction rules for certain transactions.¹³⁶ Present law does not provide a statutory prohibited transaction exemption for cross trades.

Explanation of Provision

The provision provides prohibited transaction exemptions under ERISA and the Code for a transaction involving the purchase and sale of a security between a plan and any other account managed by the same investment manager if certain requirements are met. These requirements are—

- the transaction is a purchase or sale, for no consideration other than cash payment against prompt delivery of a security for which market quotations are readily available;
- the transaction is effected at the independent current market price of the security;
- no brokerage commission fee (except for customary transfer fees, the fact of which is disclosed) or other remuneration is paid in connection with the transaction;
- a fiduciary (other than the investment manager engaging in the cross trades or any affiliate) for each plan participating in the transaction authorizes in advance of any cross-trades (in a document that is separate from any other written agreement of the parties) the investment manager to engage in cross trades at the investment manager's discretion, after the fiduciary has received disclosure regarding the conditions under which cross trades may take place (but only if the disclosure is separate from any other agreement or disclosure involving the asset management relationship), including the written policies and procedures of the investment manager;
- each plan participating in the transaction has assets of at least \$100,000,000, except that, if the assets of a plan are invested in a master trust containing the assets of plans maintained by employers in the same controlled group, the master trust has assets of at least \$100,000,000;
- the investment manager provides to the plan fiduciary who has authorized cross trading a quarterly report detailing all cross trades executed by the investment manager in which the plan participated during such quarter, including the following information as applicable: the identity of each security bought or sold, the number of

¹³⁶ In addition, under ERISA section 408(a), the Secretary of Labor may grant exemptions with respect to particular transactions or classes of transactions after consultation and coordination with the Secretary of Treasury. An exemption may not be granted unless the Secretary of Labor finds that the exemption is administratively feasible, in the interests of the plan and its participants and beneficiaries, and protective of the rights of plan participants and beneficiaries.

shares or units traded, the parties involved in the cross trade, and the trade price and the method used to establish the trade price;

- the investment manager does not base its fee schedule on the plan's consent to cross trading and no other service (other than the investment opportunities and cost savings available through a cross trade) is conditioned on the plan's consent to cross trading;
- the investment manager has adopted, and cross trades are effected in accordance with, written cross-trading policies and procedures that are fair and equitable to all accounts participating in the cross-trading program and that include a description of the manager's pricing policies and procedures, and the manager's policies and procedures for allocating cross trades in an objective manner among accounts participating in the cross-trading program; and
- the investment manager has designated an individual responsible for periodically reviewing purchases and sales to ensure compliance with the written policies and procedures and, following such review, the individual must issue an annual written report no later than 90 days following the period to which it relates, signed under penalty of perjury, to the plan fiduciary who authorized the cross trading, describing the steps performed during the course of the review, the level of compliance, and any specific instances of noncompliance.

The written report must also notify the plan fiduciary of the plan's right to terminate participation in the investment manager's cross-trading program at any time.

No later than 180 days after the date of enactment, the Secretary of Labor, after consultation with the Securities and Exchange Commission, is directed to issue regulations regarding the content of policies and procedures required to be adopted by an investment manager under the requirements for the exemption.

Effective Date

The provision is effective with respect to transactions occurring after the date of enactment.

**C. Correction Period for Certain Transactions Involving
Securities and Commodities
(sec. 408 of ERISA, and sec. 4975 of the Code)**

Present Law

ERISA and the Code prohibit certain transactions between an employer-sponsored retirement plan and a disqualified person (referred to as a “party in interest” under ERISA).¹³⁷ Disqualified persons include a fiduciary of the plan, a person providing services to the plan, and an employer with employees covered by the plan. For this purpose, a fiduciary includes any person who (1) exercises any authority or control respecting management or disposition of the plan’s assets, (2) renders investment advice for a fee or other compensation with respect to any plan moneys or property, or has the authority or responsibility to do so, or (3) has any discretionary authority or responsibility in the administration of the plan.

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

Under the Code, if a prohibited transaction occurs, the disqualified person who participates in the transaction is subject to a two-tier excise tax. The first level tax is 15 percent of the amount involved in the transaction. The second level tax is imposed if the prohibited transaction is not corrected within a certain period and is 100 percent of the amount involved. Under ERISA, the Secretary of Labor may assess a civil penalty against a person who engages in a prohibited transaction, other than a transaction with a plan covered by the prohibited transaction rules of the Code (i.e., involving a qualified retirement plan or annuity). The penalty may not exceed five percent of the amount involved in the transaction. If the prohibited transaction is not corrected within 90 days after notice from the Secretary of Labor, the penalty may be up to 100 percent of the amount involved in the transaction.¹³⁸ For purposes of these

¹³⁷ Under ERISA, the prohibited transaction rules apply to employer-sponsored retirement plans and welfare benefit plans. Under the Code, the prohibited transaction rules apply to qualified retirement plans and qualified retirement annuities, as well as individual retirement accounts and annuities, Archer MSAs, health savings accounts, and Coverdell education savings accounts. The prohibited transaction rules under ERISA and the Code generally do not apply to governmental plans or church plans.

¹³⁸ A prohibited transaction violates the fiduciary responsibility provisions of ERISA. Under section 502(l) of ERISA, in the case of a violation of fiduciary responsibility, a civil penalty is generally imposed of 20 percent of the amount recovered from a person with respect to the violation in a settlement agreement with the Department of Labor or a judicial proceeding, but the penalty is reduced by the amount of any excise tax or other civil penalty with respect to a prohibited transaction.

rules, the “amount involved” generally means the greater of (1) the amount of money and the fair market value of the other property given, or (2) the amount of money and the fair market value of other property received by the plan. The terms “correction” and “correct” mean, with respect to a prohibited transaction, undoing the transaction to the extent possible, but in any case placing the plan in a financial position not worse than the position in which it would be if the disqualified person were acting under the highest fiduciary standards.

For purposes of the prohibited transaction rules of the Code and ERISA, a transaction involving the sale of securities is considered to occur when the transaction is settled (that is, an actual change in ownership of the securities). Under current practice, securities transactions are commonly settled 3 days after the agreement to sell is made. Present law does not provide a statutory prohibited transaction exemption that is based solely on correction of the transaction.

Explanation of Provision

The bill provides a prohibited transaction exemption under ERISA and the Code for a transaction in connection with the acquisition, holding, or disposition of any security or commodity if the transaction is corrected within a certain period, generally within 14 days of the date the disqualified person (or other person knowingly participating in the transaction) discovers, or reasonably should have discovered, the transaction was a prohibited transaction. For this purpose, the term “correct” means, with respect to a transaction: (1) to undo the transaction to the extent possible and in any case to make good to the plan or affected account any losses resulting from the transaction; and (2) to restore to the plan or affected account any profits made through the use of assets of the plan. If the exemption applies, no excise tax is to be assessed with the transaction, any tax assessed is to be abated, and any tax collected is to be credited or refunded as a tax overpayment.

The exemption does not apply to any transaction between a plan and a plan sponsor or its affiliates that involves the acquisition or sale of an employer security or the acquisition, sale, or lease of employer real property. In addition, in the case of a disqualified person (or other person knowingly participating in the transaction), the exemption does not apply if, at the time of the transaction, the person knew (or reasonably should have known) that the transaction would constitute a prohibited transaction.

Effective Date

The provision is effective with respect to any transaction that a fiduciary or other person discovers, or reasonably should have discovered, after the date of enactment constitutes a prohibited transaction.

**D. Inapplicability of Relief from Fiduciary Liability During Suspension of Ability
of Participant or Beneficiary to Direct Investments
(sec. 404(c) of ERISA)**

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 the care, skill, prudence, and diligence under the circumstances then prevailing that a prudent man acting in a like capacity and familiar with such matters would use in the conduct of an enterprise of a like character and with like aims. 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.

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 in the case of 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.

Regulations issued by the Department of Labor describe the requirements that must be met in order for a participant to be treated as exercising control over the assets in his or her account. With respect to investment options, the regulations provide in part:

- 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);

- 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 and the other requirements under the regulations 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.

Blackout notice

Under ERISA, the plan administrator of a defined contribution plan generally must provide at least 30 days advance notice of a blackout period (a "blackout notice") to plan participants and beneficiaries to whom the blackout period applies.¹³⁹ Failure to provide a blackout notice may result in a civil penalty up to \$100 per day for each failure with respect to a single participant or beneficiary.

A blackout period is any period during which any ability of participants or beneficiaries under the plan, which is otherwise available under the terms of the plan, to direct or diversify assets credited to their accounts, or to obtain loans or distributions from the plan, is temporarily suspended, limited, or restricted if the suspension, limitation, or restriction is for any period of more than three consecutive business days. However, a blackout period does not include a suspension, limitation, or restriction that (1) occurs by reason of the application of securities laws, (2) is a change to the plan providing for a regularly scheduled suspension, limitation, or restriction that is disclosed through a summary of material modifications to the plan or materials describing specific investment options under the plan, or changes thereto, or (3) applies only to one or more individuals, each of whom is a participant, alternate payee, or other beneficiary under a qualified domestic relations order.

A blackout notice must be written in a manner calculated to be understood by the average plan participant and must include (1) the reasons for the blackout period, (2) an identification of the investments and other rights affected, (3) the expected beginning date and length of the blackout period, and (4) in the case of a blackout period affecting investments, a statement that the participant or beneficiary should evaluate the appropriateness of current investment decisions in light of the inability to direct or diversify assets during the blackout period, and (5) other matters as required by regulations. If the expected beginning date or length of the blackout period changes after notice has been provided, the plan administrator must provide notice of the change (and specify any material change in other matters related to the blackout) to affected participants and beneficiaries as soon as reasonably practicable.

¹³⁹ ERISA sec. 101(i).

Explanation of Provision

The bill amends the special rule applicable if a participant exercises control over the assets in his or her account with respect to a case in which a qualified change in investment options offered under the defined contribution plan occurs. In such a case, for purposes of the special rule, a participant or beneficiary who has exercised control over the assets in his or her account before a change in investment options is not treated as not exercising control over such assets in connection with the change if certain requirements are met.

For this purpose, a qualified change in investment options means a change in the investment options offered to a participant or beneficiary under the terms of the plan, under which: (1) the participant's account is reallocated among one or more new investment options offered instead of one or more investment options that were offered immediately before the effective date of the change; and (2) the characteristics of the new investment options, including characteristics relating to risk and rate of return, are, immediately after the change, reasonably similar to the characteristics of the investment options offered immediately before the change.

The following requirements must be met in order for the rule to apply: (1) at least 30 but not more than 60 days before the effective date of the change in investment options, the plan administrator furnishes written notice of the change to participants and beneficiaries, including information comparing the existing and new investment options and an explanation that, in the absence of affirmative investment instructions from the participant or beneficiary to the contrary, the account of the participant or beneficiary will be invested in new options with characteristics reasonably similar to the characteristics of the existing investment options; (2) the participant or beneficiary has not provided to the plan administrator, in advance of the effective date of the change, affirmative investment instructions contrary to the proposed reinvestment of the participant's or beneficiary's account; and (3) the investment of the participant's or beneficiary's account as in effect immediately before the effective date of the change was the product of the exercise by such participant or beneficiary of control over the assets of the account.

In addition, the provision amends the special rule applicable if a participant or beneficiary exercises control over the assets in his or her account so that the provision under which no person who is otherwise a fiduciary is liable for any loss, or by reason of any breach, that results from the participant's or beneficiary's exercise of control does not apply in connection with a blackout period¹⁴⁰ in which the participant's or beneficiary's ability to direct the assets in his or her account is suspended by a plan sponsor or fiduciary. However, if a plan sponsor or fiduciary meets the requirements of ERISA in connection with authorizing and implementing a blackout period, any person who is otherwise a fiduciary is not liable under ERISA for any loss occurring during the blackout period.

Not later than one year after the date of enactment, the Secretary of Labor is to issue interim final regulations providing guidance, including safe harbors, on how plan sponsors or other affected fiduciaries can satisfy their fiduciary responsibilities during any blackout period.

¹⁴⁰ For this purpose, blackout period is defined as under the present-law provision requiring advance notice of a blackout period.

Effective Date

The provision generally applies to plan years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2008 or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2009.

**E. Increase in Maximum Bond Amount
(sec. 412(a) of ERISA)**

Present Law

ERISA generally requires every plan 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 bond is intended to protect plans against loss from acts of fraud or dishonesty by plan officials. Qualifying bonds must have as surety a corporate surety company that is an acceptable surety on Federal bonds.

Explanation of Provision

The provision raises the maximum bond amount to \$1 million in the case of a plan that holds employer securities. The provision raises the maximum bond amount to \$1 million in the case of a plan that holds employer securities. A plan would not be considered to hold employer securities within the meaning of this section where the only securities held by the plan are part of a broadly diversified fund of assets, such as mutual or index funds.

Effective Date

The provision is effective for plan years beginning after December 31, 2007.

**F. Increase in Penalties for Coercive Interference
with Exercise of ERISA Rights
(sec. 511 of ERISA)**

Present Law

ERISA prohibits any person from using fraud, force or violence (or threatening force or violence) to restrain, coerce, or intimidate (or attempt to) any plan participant or beneficiary in order to interfere with or prevent the exercise of their rights under the plan, ERISA, or the Welfare and Pension Plans Disclosure Act (“WPPDA”). Willful violation of this prohibition is a criminal offense subject to a \$10,000 fine or imprisonment of up to one year, or both.

Explanation of Provision

The provision increases the penalties for willful acts of coercive interference with participants’ rights under a plan, ERISA, or the WPPDA. The amount of the fine is increased to \$100,000, and the maximum term of imprisonment is increased to 10 years.

Effective Date

The provision is effective for violations occurring on and after the date of enactment.

**G. Treatment of Investment of Assets By Plan Where Participant
Fails to Exercise Investment Election
(sec. 404(c) of ERISA)**

Present Law

ERISA imposes standards on the conduct of plan fiduciaries, including persons who make investment decisions with respect to plan assets. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An individual account plan may permit participants to make investment decisions with respect to their accounts. ERISA fiduciary liability does not apply to investment decisions made by plan participants if participants exercise control over the investment of their individual accounts, as determined under ERISA regulations. In that case, a plan fiduciary may be responsible for the investment alternatives made available, but not for the specific investment decisions made by participants.

Explanation of Provision

Under the bill, a participant is treated as exercising control with respect to assets in an individual account plan if such amounts are invested in a default arrangement in accordance with Department of Labor regulations until the participant makes an affirmative election regarding investments. Such regulations must provide guidance on the appropriateness of certain investments for designation as default investments under the arrangement, including guidance regarding appropriate mixes of default investments and asset classes which the Secretary considers consistent with long-term capital appreciation or long-term capital preservation (or both), and the designation of other default investments. The Secretary of Labor is directed to issue regulations under the provision within six months of the date of enactment.

In order for this treatment to apply, notice of the participant's rights and obligations under the arrangement must be provided. Under the notice requirement, within a reasonable period before the plan year, the plan administrator must give each participant notice of the rights and obligations under the arrangement which is sufficiently accurate and comprehensive to apprise the participant of such rights and obligations and is written in a manner to be understood by the average participant. The notice must include an explanation of the participant's rights under the arrangement to specifically elect to exercise control over the assets in the participant's account. In addition, the participant must have a reasonable period of time after receipt of the notice and before the assets are first invested to make such an election. The notice must also explain how contributions made under the arrangement will be invested in the absence of any investment election by the employee.

Effective Date

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

H. Clarification of Fiduciary Rules

Present Law

ERISA imposes standards on the conduct of plan fiduciaries. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An ERISA interpretive bulletin requires a fiduciary choosing an annuity provider for purposes of distributions from a plan (whether on separation or retirement of a participant or on termination of the plan) to take steps calculated to obtain the safest available annuity, based on the annuity provider's claims paying ability and creditworthiness, unless under the circumstances it would be in the interest of participants to do otherwise.¹⁴¹

Explanation of Provision

The bill directs the Secretary of Labor to issue final regulations within one year of the date of enactment, clarifying that the selection of an annuity contract as an optional form of distribution from a defined contribution plan is not subject to the safest available annuity requirement under the ERISA interpretive bulletin and is subject to all otherwise applicable fiduciary standards.

The regulations to be issued by the Secretary of Labor are intended to clarify that the plan sponsor or other applicable plan fiduciary is required to act in accordance with the prudence standards of ERISA section 404(a). It is not intended that there be a single safest available annuity contract since the plan fiduciary must select the most prudent option specific to its plan and its participants and beneficiaries. Furthermore, it is not intended that the regulations restate all of the factors contained in the interpretive bulletin.

Effective Date

The provision is effective on the date of enactment.

¹⁴¹ 29 C.F.R. sec. 2509.95-1 (2005).

TITLE VII: BENEFIT ACCRUAL STANDARDS

(Secs. 203, 204, and 205 of ERISA, secs. 411 and 417 of the Code, and sec. 4(i)(2) of ADEA)

Present Law

Prohibition on age discrimination

In general

A prohibition on age discrimination applies to benefit accruals under a defined benefit pension plan.¹⁴² Specifically, an employee's benefit accrual may not cease, and the rate of an employee's benefit accrual may not be reduced, because of the attainment of any age. However, this prohibition is not violated solely because the plan imposes (without regard to age) a limit on the amount of benefits that the plan provides or a limit on the number of years of service or years of participation that are taken into account for purposes of determining benefit accrual under the plan. Moreover, for purposes of this requirement, the subsidized portion of any early retirement benefit may be disregarded in determining benefit accruals.

In December 2002, the IRS issued proposed regulations that dealt with the application of the age discrimination rules.¹⁴³ The proposed regulations included rules for applying the age discrimination rules with respect to accrued benefits, optional forms of benefit, ancillary benefits, and other rights and features provided under a plan. Under the proposed regulations, for purposes of applying the prohibition on age discrimination to defined benefit pension plans, an employee's rate of benefit accrual for a year is generally the increase in the employee's accrued normal retirement benefit (i.e., the benefit payable at normal retirement age) for the plan year. In the preamble to the proposed regulations, the IRS requested comments on other approaches to determining the rate of benefit accrual, such as allowing accrual rates to be averaged over multiple years (for example, to accommodate plans that provide a higher rate of accrual in earlier years) or, in the case of a plan that applies an offset, determining accrual rates before application of the offset. As discussed below, in June 2004, the IRS announced the withdrawal of the proposed regulations.

Cash balance and other hybrid plans

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

Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee's hypothetical account balance is determined by reference to hypothetical annual allocations to the account ("pay credits") (e.g., a certain percentage of the employee's compensation for the year) and hypothetical earnings on the account ("interest credits"). Cash

¹⁴² Code sec. 411(b)(1)(H); ERISA sec. 204(b)(1)(H).

¹⁴³ 67 Fed. Reg. 76123.

balance plans are generally designed so that, when a participant receives a pay credit for a year of service, the participant also receives the right to future interest on the pay credit, regardless of whether the participant continues employment (referred to as “front-loaded” interest credits). That is, the participant’s hypothetical account continues to be credited with interest after the participant stops working for the employer. As a result, if an employee terminates employment and defers distribution to a later date, interest credits will continue to be credited to that employee’s hypothetical account.

Another type of hybrid plan is a pension equity plan (sometimes referred to as a “PEP”). Under a pension equity plan, benefits are generally described as a percentage of final average pay, with the percentage determined on the basis of points received for each year of service, which are often weighted for older or longer service employees. Pension equity plans commonly provide interest credits for the period between a participant’s termination of employment and commencement of benefits.

Because of the front-loaded nature of accruals under cash balance plans, there is a longer time for interest credits to accrue on a pay credit to the account of a younger employee. Thus, a pay credit received at a younger age may provide a larger annuity benefit at normal retirement age than the same pay credit received at an older age. A similar effect may occur with respect to other types of hybrid plan designs, including pension equity plans.

IRS consideration of cash balance plans began in the early 1990s.¹⁴⁴ At that time, the focus was on the question of whether such plans satisfied the nondiscrimination requirements under section 401(a)(4), which requires that benefits or contributions not discriminate in favor of highly compensated employees. Treasury regulations issued in 1991 under section 401(a)(4) provided a safe harbor for cash balance plans that provide frontloaded interest credits and meet certain other requirements. In connection with the issuance of these regulations, Treasury spoke to the cash balance age discrimination issue. The preamble to the final regulations stated “[t]he fact that interest adjustments through normal retirement age are accrued in the year of the related hypothetical allocation will not cause a cash balance plan to fail to satisfy the requirements of section 411(b)(1)(H), relating to age-based reductions in the rate at which benefits accrue under a plan.”¹⁴⁵ Many interpreted this language as Treasury’s position that cash balance plan designs do not violate the prohibitions on age discrimination. The IRS has not to date asserted that hybrid plan formulas result in per se violations of age discrimination requirements. In 1999, Treasury and the IRS issued an announcement and a Federal Register notice stating that the question of whether cash balance conversions were age discriminatory or otherwise inconsistent with plan qualification rules was under active consideration, that further IRS determination letters on conversions to cash balance plans would therefore be suspected be referral to the IRS National Office until the IRS and Treasury had resolved the issues, and inviting public comment on the issues. Hundreds of comments were submitted. The December 2002 proposed regulations, noted above, provided that an employee’s rate of benefit accrual for a year is

¹⁴⁴ Statement of Stuart L. Brown, Chief Counsel Internal Revenue Service, before the Senate Committee on Health, Education, Labor, and Pensions (Sept. 21, 1999).

¹⁴⁵ 56 Fed. Reg. 47528 (Sept. 19, 1991).

generally the increase in the employee's accrued normal retirement benefit (i.e., the benefit payable at normal retirement age) for the plan year. However, the proposed regulations provided a special rule under which an employee's rate of benefit accrual under a cash balance plan meeting certain requirements (an "eligible" cash balance plan) was based on the rate of pay credit provided under the plan. Thus, under the proposed regulations, an eligible cash balance plan would not violate the prohibition on age discrimination solely because pay credits for younger employees earn interest credits for a longer period.

Section 205 of the Consolidated Appropriations Act, 2004 (the "2004 Appropriations Act"), enacted January 24, 2004, provides that none of the funds made available in the 2004 Appropriations Act may be used by the Secretary of the Treasury, or his designee, to issue any rule or regulation implementing the 2002 proposed Treasury age discrimination regulations or any regulation reaching similar results.¹⁴⁶ The 2004 Appropriations Act also required the Secretary of the Treasury within 180 days of enactment to present to Congress a legislative proposal for providing transition relief for older and longer-service participants affected by conversions of their employers' traditional pension plans to cash balance plans. The Treasury Department complied with this requirement by including in the President's budget for fiscal year 2005 a proposal relating to cash balance and other hybrid plans that specifically addresses conversions to such plans, the application of the age discrimination rules to such plans, and the determination of minimum lump sums under such plans.¹⁴⁷ In June 2004, the IRS announced the withdrawal of the proposed age discrimination regulations, including the special rules for eligible cash balance plans.¹⁴⁸ According to the Announcement, "[t]his will provide Congress an opportunity to . . . address cash balance and other hybrid plan issues through legislation."

The application of the age discrimination rules to hybrid plans has been the subject of litigation. The decisions are divided on how ERISA requires courts to calculate the rate of benefit accrual.¹⁴⁹

Calculating minimum lump-sum distributions under hybrid plans

Defined benefit pension plans, including cash balance plans and other hybrid plans, are required to provide benefits in the form of a life annuity commencing at a participant's normal retirement age. If the plan permits benefits to be paid in certain other forms, such as a lump sum,

¹⁴⁶ Pub. L. No. 108-199 (2004).

¹⁴⁷ A similar proposal was also contained in the President's budget proposal for fiscal year 2006.

¹⁴⁸ IRS Announcement 2004-57, 2004-27 I.R.B. 15.

¹⁴⁹ Compare *Register v. PNC Financial Services Group, Inc.* No. 04-CV-6097, 2005 WL 3120268 (E.D. Pa. Nov. 21, 2005), *Tootle v. ARINC, Inc.*, 222 F.R.D. 88 (D. Md. 2004); *Eaton v. Oanan Corp.*, 117 F. Supp. 2d 812 (S.D. Ind. 2000); with *Cooper v. IBM Personal Pension Plan*, 274 F. Supp.2d 1010 (S.D. Ill. 2003), *Richards v. Fleetboston Financial Corp.*, 427 F.Supp.2d 150 (D. Conn. 2006), *Donaldson v. Pharmacia Pension Plan*, 2006 WL 1669789, 38 E.B.C. 1006 (S.D. Ill. June 14, 2006). See also *Campbell v. BankBoston*, 327 F.3d 1 (1st Cir. 2003) and *Hirt v. Equitable Retirement Plan for Employees, Managers and Agents* No. 01 Civ. 7920 (AKH), 2006 WL 2023545 (S.D.N.Y. July 20, 2006).

minimum present value rules apply, under which the alternative form of benefit cannot be less than the present value of the life annuity payable at normal retirement age, determined using certain statutorily prescribed interest and mortality assumptions.¹⁵⁰

Most cash balance plans are designed to permit a lump-sum distribution of a participant's hypothetical account balance upon termination of employment. This raises an issue as to the whether a distribution of a participant's hypothetical account balance satisfies the minimum present value rules. In 1996, the IRS issued proposed guidance (Notice 96-8) on the application of the minimum present value rules to lump-sum distributions under cash balance plans and requested public comments in anticipation of proposed regulations incorporating the proposed guidance.¹⁵¹

Under the proposed guidance, a lump-sum distribution from a cash balance plan cannot be less than the present value of the benefit payable at normal retirement age, determined using the statutory interest and mortality assumptions. For this purpose, a participant's normal retirement benefit under a cash balance plan is generally determined by projecting the participant's hypothetical account balance to normal retirement age by crediting to the account future interest credits at the plan rate, the right to which has already accrued, and converting the projected account balance to an actuarially equivalent life annuity payable at normal retirement age, using the interest and mortality assumptions specified in the plan. The proposed guidance also included rules under which cash balance plans can provide lump-sum distributions in the amount of participants' hypothetical account balances if the rate at which interest credits are provided under the plan is not greater (or is assumed not to be greater) than the statutory interest rate.

Under the approach in the proposed guidance, a difference in the rate of interest credits provided under the plan, which is used to project the account balance forward to normal retirement age, and the statutory rate used to determine the lump-sum value (i.e., present value) of the accrued benefit can cause a discrepancy between the value of the minimum lump-sum and the employee's hypothetical account balance. This effect is sometimes referred to as "whipsaw." In particular, if the plan's interest crediting rate is higher than the statutory interest rate, then the resulting lump-sum amount will generally be greater than the hypothetical account balance.

¹⁵⁰ Code sec. 417(e); ERISA sec. 205(g)(3). For years before 1995, these provisions required the use of an interest rate based on interest rates determined by the PBGC. For years after 1994, these provisions require the use of an interest rate based on interest rates on 30-year Treasury securities and a mortality table specified by the IRS.

¹⁵¹ Notice 96-8, 1996-1996-1 C.B. 359. The Notice provides that regulations will be effective prospectively and, for plan years before regulations are effective, allows lump-sum distributions from cash balance plans that provide front-loaded interest credits to be based on a reasonable, good-faith interpretation of the minimum present value rules, taking into account preexisting guidance. The Notice further provides that plans that comply with the guidance in the Notice are deemed to be applying a reasonable, good-faith interpretation.

Several courts, but not all, have applied an approach similar to the approach in the proposed guidance in cases involving the determination of lump sums under cash balance plans.¹⁵² Regulations addressing the application of the minimum present value rules to cash balance plans have not been issued.¹⁵³

Explanation of Provision

Age discrimination rules in general

Under the provision, a plan is not treated as violating the prohibition on age discrimination under ERISA, the Code, and ADEA if a participant's accrued benefit,¹⁵⁴ as determined as of any date under the terms of the plan would be equal to or greater than that of any similarly situated, younger individual who is or could be a participant. For this purpose, an individual is similarly situated to a participant if the individual and the participant are (and always have been) identical in every respect (including period of service, compensation, position, date of hire, work history, and any other respect) except for age. Under the provision, the comparison of benefits for older and younger participants applies to all possible participants under all possible dates under the plan, in the same manner as the present-law application of the backloading and accrual rules.

In addition, in determining a participant's accrued benefit for this purpose, the subsidized portion of any early retirement benefit or any retirement type subsidy is disregarded. In some cases the value of an early retirement subsidy may be difficult to determine; it is therefore intended that a reasonable approximation of such value may be used for this purpose. In calculating the accrued benefit, the benefit may, under the terms of the plan, be calculated as an annuity payable at normal retirement age, the balance of a hypothetical account, or the current value of the accumulated percentage of the employee's final average compensation. That is, the

¹⁵² *Berger v. Xerox Corp. Retirement Income Guarantee Plan*, 338 F.3d 755 (7th Cir. 2003); *Esden v. Bank of Boston*, 229 F.3d 154 (2d Cir. 2000), cert. dismissed, 531 U.S. 1061 (2001); *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 221 F.3d 1235 (11th Cir. 2000) ("*Lyons II*"), cert. denied, 532 U.S. 967 (2001); and *West v. AK Steel Corp. Retirement Accumulation Plan*, 318 F. Supp.2d 579 (S.D. Ohio 2004). In *Lyons II*, the court reversed a lower court holding in *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 66 F. Supp.2d 1328 (N.D. Ga. 1999) ("*Lyons I*"), relating to the application of the minimum present value rules in effect before 1995. The *Lyons II* court limited its analysis to the minimum present value rules in effect as of 1993 when Mr. Lyons received his lump-sum distribution; however, the court indicated that a different result could apply under the law in effect after 1994. On remand, in *Lyons v. Georgia Pacific Salaried Employees Retirement Plan*, 196 F. Supp.2d 1260 (N.D. Ga. 2002) ("*Lyons III*"), the lower court determined that payment of the hypothetical account balance did not violate the minimum present value rules in effect for years after 1994.

¹⁵³ As mentioned above, the President's budgets for fiscal years 2005 and 2006 include a proposal relating to cash balance plans that specifically addresses the determination of minimum lump sums under such plans. The President's proposal would eliminate the whipsaw effect and allow the plan to pay the hypothetical account balance, if certain requirements are satisfied.

¹⁵⁴ For purposes of this rule, the accrued benefit means such benefit accrued to date.

age discrimination rules may be applied on the basis of the balance of the a hypothetical account or the current value of the accumulated percentage of the employee's final average compensation, but only if the plan terms provide the accrued benefit in such form. The provision is intended to apply to hybrid plans, including pension equity plans.

The provision makes it clear that a plan is not treated as age discriminatory solely because the plan provides offsets of benefits under the plan to the extent such offsets are allowable in applying the requirements under section 401(a) of the Code. It is intended that such offsets also comply with ERISA and the ADEA.

A plan is not treated as failing to meet the age discrimination requirements solely because the plan provides a disparity in contributions and benefits with respect to which the requirements of section 401(l) of the Code are met.

A plan is not treated as failing to meet the age discrimination requirements solely because the plan provides for indexing of accrued benefits under the plan. Except in the case of any benefit provided in the form of a variable annuity, this rule does not apply with respect to any indexing which results in an accrued benefit less than the accrued benefit determined without regard to such indexing. Indexing for this purpose means, with respect to an accrued benefit, the periodic adjustment of the accrued benefit by means of the application of a recognized investment index or methodology. Under the provision, in no event may indexing be reduced or cease because of age.

Rules for applicable defined benefit plans

In general

Under the provision, an applicable defined benefit plan fails to satisfy the age discrimination rules unless the plan meets certain requirements with respect to interest credits and, in the case of a conversion, certain additional requirements. Applicable defined benefit plans must also satisfy certain vesting requirements.

Interest requirement

A plan satisfies the interest requirement if the terms of the plan provide that any interest credit (or equivalent amount) for any plan year is at a rate that is not less than zero and is not greater than a market rate of return. A plan does not fail to meet the interest requirement merely because the plan provides for a reasonable minimum guaranteed rate of return or for a rate or return that is equal to the greater of a fixed or variable rate of return. An interest credit (or an equivalent amount) of less than zero cannot result in the account balance or similar amount being less than the aggregate amount of contributions credited to the account. The Secretary of the Treasury may provide rules governing the calculation of a market rate of return and for permissible methods of crediting interest to the account (including fixed or variable interest rates) resulting in effective rates of return that meet the requirements of the provision.

If the interest credit rate (or equivalent amount) is a variable rate, the plan must provide that, upon termination of the plan, the rate of interest used to determine accrued benefits under

the plan is equal to the average of the rates of interest used under the plan during the five-year period ending on the termination date.

Conversion rules

Under the provision, special rules apply if an amendment to a defined benefit plan is adopted which would have the effect of converting the plan into an applicable defined benefit plan (an “applicable plan amendment”).¹⁵⁵ If an applicable plan amendment is adopted after June 29, 2005, the plan fails to satisfy the age discrimination rules unless the plan provides that the accrued benefit of any individual who was a participant immediately before the adoption of the amendment is not less than the sum of (1) the participant’s accrued benefit for years of service before the effective date of the amendment, determined under the terms of the plan as in effect before the amendment; plus (2) the participant’s accrued benefit for years of service after the effective date of the amendment, determined under the terms of the plan as in effect after the terms of the amendment.

For purposes of determining the amount in (1) above, the plan must credit the accumulation account or similar amount with the amount of any early retirement benefit or retirement-type subsidy for the plan year in which the participant retires if, as of such time, the participant has met the age, years of service, and other requirements under the plan for entitlement to such benefit or subsidy.

Vesting rules

The provision amends the ERISA and Code rules relating to vesting to provide that an applicable defined benefit plan must provide that each employee who has completed at least three years of service has a nonforfeitable right to 100 percent of the employee’s accrued benefit derived from employer contributions.

Minimum present value rules

The provision provides that an applicable defined benefit plan is not treated as failing to meet the minimum present value rules¹⁵⁶ solely because of the present value of the accrued benefit (or any portion thereof) of any participant is, under the terms of the plan, equal to the

¹⁵⁵ If the benefits under two or more defined benefit plans established by an employer are coordinated in such a manner as to have the effect of the adoption of an applicable plan amendment, the sponsor of the defined benefit plan or plans providing for the coordination is treated as having adopted an applicable plan amendment as of the date the coordination begins. In addition, the Secretary of Treasury is directed to issue regulations to prevent the avoidance of the requirements with respect to an applicable plan amendment through the use of two or more plan amendments rather than a single amendment.

¹⁵⁶ ERISA sec. 205(g), Code sec. 417(e). A plan complying with the provision also does not violate certain rules relating to vesting (ERISA sec. 203(a)(2) and Code sec. 411(a)(2)) and the determination of the accrued benefit (in the case of a plan which does not provide for employee contributions) (ERISA sec. 204(c) and Code sec. 411(c)).

amount expressed as the balance in the hypothetical account or as an accumulated percentage of the participant's final average compensation.

Rules on plan termination

The provision provides rules for making determinations of benefits upon termination of an applicable defined benefit plan. Such a plan must provide that, upon plan termination, (1) if the interest credit rate (or equivalent amount) under the plan is a variable rate, the rate of interest used to determine accrued benefits under the plan shall be equal to the average of the rates of interest used under the plan during the five-year period ending on the termination date and (2) the interest rate and mortality table used to determine the amount of any benefit under the plan payable in the form of an annuity payable at normal retirement age is the rate and table specified under the plan for such purposes as of the termination date. For purposes of (2), if the rate of interest is a variable rate, then the rate is the average of such rates during the five-year period ending on the termination date.

Definition of applicable defined benefit plan

An applicable defined benefit plan is a defined benefit plan under which the accrued benefit (or any portion thereof) is calculated as the balance of a hypothetical account maintained for the participant or as an accumulated percentage of the participant's final average compensation. The Secretary of the Treasury is to provide rules which include in the definition of an applicable defined benefit plan any defined benefit plan (or portion of such a plan) which has an effect similar to an applicable defined benefit plan.

No inference

Nothing in the provision is to be construed to infer the treatment of applicable defined benefit plans or conversions to such plans under the rules in ERISA, ADEA and the Code prohibiting age discrimination¹⁵⁷ as in effect before the provision is effective. In addition, no inference is to be drawn with respect to the application of the minimum benefit rules to applicable defined benefit plans before the provision is effective.

Regulations relating to mergers and acquisitions

The Secretary of the Treasury is directed to prescribe regulations for the application of the provisions relating to applicable defined benefit plans in cases where the conversion of a plan to a cash balance or similar plan is made with respect to a group of employees who become employees by reason of a merger, acquisition, or similar treatment. The regulations are to be issued not later than 12 months after the date of enactment.

Effective Date

In general, the provision is effective for periods beginning on or after June 29, 2005.

¹⁵⁷ ERISA sec. 204(b)(1)(H), ADEA sec. 4(i)(1), and Code sec. 411(b)(1)(H).

The provision relating to the minimum value rules is effective for distributions after the date of enactment.

In the case of a plan in existence on June 29, 2005, the interest credit and vesting requirements for an applicable defined benefit plan generally apply to years beginning after December 31, 2007, except that the plan sponsor may elect to have such requirements apply for any period after June 29, 2005, and before the first plan year beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, a delayed effective date applies with respect to the interest credit and vesting requirements for an applicable defined benefit plan.

The provision relating to conversions of plans applies to plan amendments adopted after and taking effect after June 29, 2005, except that a plan sponsor may elect to have such amendments apply to plan amendments adopted before and taking affect after such date.

The direction to the Secretary of the Treasury to issue regulations relating to mergers and acquisitions is effective on the date of enactment.

TITLE VIII: PENSION RELATED REVENUE PROVISIONS

A. Deduction Limitations

1. Increase in deduction limits applicable to single-employer and multiemployer defined benefit pension plans (sec. 404 of the Code)

Present Law

In general

Employer contributions to qualified retirement plans are deductible subject to certain limits.

In the case of contributions to a defined benefit pension plan (including both single-employer and multiemployer plans), the employer generally may deduct the greater of: (1) the amount necessary to satisfy the minimum funding requirement of the plan for the year; or (2) the amount of the plan's normal cost for the year plus the amount necessary to amortize certain unfunded liabilities over 10 years, but limited to the full funding limitation for the year.¹⁵⁸ The maximum amount otherwise deductible generally is not less than the plan's unfunded current liability.¹⁵⁹ In the case of a single-employer plan covered by the PBGC insurance program that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of plan termination under the PBGC insurance program ("unfunded termination liability"). In applying these limits, future increases in the limits on compensation taken into account under a qualified retirement plan and on benefits payable under a defined benefit pension plan may not be taken into account.

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

Overall deduction limit

If an employer sponsors one or more defined benefit pension plans and one or more defined contribution plans that cover at least one of the same employees, an overall deduction limit applies to the total contributions to all plans for a plan year. The overall deduction limit is

¹⁵⁸ The full funding limitation is the excess, if any, of (1) the accrued liability of the plan (including normal cost), over (2) the lesser of (a) the market value of plan assets or (b) the actuarial value of plan assets. However, the full funding limit is not less than the excess, if any, of 90 percent of the plan's current liability (including the current liability normal cost) over the actuarial value of plan assets.

¹⁵⁹ In the case of a plan with 100 or fewer participants, unfunded current liability for this purpose does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

the greater of (1) 25 percent of compensation, or (2) the amount necessary to meet the minimum funding requirement with respect to the defined benefit plan for the year. For this purpose, the amount necessary to meet the minimum funding requirement with respect to the defined benefit plan is treated as not less than the amount of the plan's unfunded current liability.

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year.

Explanation of Provision

Single-employer defined benefit pension plans

General deduction limit

Under the bill, for taxable years beginning in 2006 and 2007, in the case of contributions to a single-employer defined benefit plan, the maximum deductible amount is not less than the excess (if any) of (1) 150 percent of the plan's current liability, over (2) the value of plan assets.

For taxable years beginning after 2007, in the case of contributions to a single-employer defined benefit pension plan, the maximum deductible amount is equal to the greater of: (1) the excess (if any) of the sum of the plan's funding target, the plan's target normal cost, and a cushion amount for a plan year, over the value of plan assets (as determined under the minimum funding rules¹⁶⁰); and (2) the minimum required contribution for the plan year.¹⁶¹

However, in the case of a plan that is not in at-risk status, the first amount above is not less than the excess (if any) of the sum of the plan's funding target and target normal cost, determined as if the plan was in at-risk status, over the value of plan assets.

The cushion amount for a plan year is the sum of (1) 50 percent of the plan's funding target for the plan year; and (2) the amount by which the plan's funding target would increase if determined by taking into account increases in participants' compensation for future years or, if the plan does not base benefits attributable to past service on compensation, increases in benefits that are expected to occur in succeeding plans year, determined on the basis of average annual benefit increases over the previous six years.¹⁶² For this purpose, the dollar limits on benefits

¹⁶⁰ In determining the maximum deductible amount, the value of plan assets is not reduced by any pre-funding balance or funding standard account carryover balance.

¹⁶¹ The bill retains the present-law rule, under which, in the case of a single-employer plan covered by the PBGC that terminates during the year, the maximum deductible amount is generally not less than the amount needed to make the plan assets sufficient to fund benefit liabilities as defined for purposes of the PBGC termination insurance program.

¹⁶² In determining the cushion amount for a plan with 100 or fewer participants, a plan's funding target does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment that is made or becomes effective, whichever is later, within the last two years.

and on compensation apply, but, in the case of a plan that is covered by the PBGC insurance program, increases in the compensation limit (under sec. 401(a)(17)) that are expected to occur in succeeding plan years may be taken into account.¹⁶³ The rules relating to projecting compensation for future years are intended solely to enable employers to reduce volatility in pension contributions; the rules are not intended to create any inference that employees have any protected interest with respect to such projected increases.

Overall deduction limit

Under the bill, in applying the overall deduction limit to contributions to one or more defined benefit pension plans and one or more defined contribution plans for years beginning after December 31, 2007, single-employer defined benefit pension plans that are covered by the PBGC insurance program are not taken into account. Thus, the deduction for contributions to a defined benefit pension plan or a defined contribution plan is not affected by the overall deduction limit merely because employees are covered by both plans if the defined benefit plan is covered by the PBGC insurance program (i.e., the separate deduction limits for contributions to defined contribution plans and defined benefit pension plans apply). In addition, in applying the overall deduction limit, the amount necessary to meet the minimum funding requirement with respect to a single-employer defined benefit pension plan that is not covered by the PBGC insurance program is treated as not less than the plan's funding shortfall (as determined under the minimum funding rules).

Multiemployer defined benefit pension plans

General deduction limit

Under the bill, for taxable years beginning after 2005, in the case of contributions to a multiemployer defined benefit pension plan, the maximum deductible amount is not less than the excess (if any) of (1) 140 percent of the plan's current liability, over (2) the value of plan assets.

Overall deduction limit

Under the bill, for taxable years beginning after December 31, 2005, in applying the overall deduction limit to contributions to one or more defined benefit pension plans and one or more defined contribution plans, multiemployer plans are not taken into account. Thus, the deduction for contributions to a defined benefit pension plan or a defined contribution plan is not affected by the overall deduction limit merely because employees are covered by both plans if either plan is a multiemployer plan (i.e., the separate deduction limits for contributions to defined contribution plans and defined benefit pension plans apply).

¹⁶³ Expected increases in the limitations on benefits under section 415, however, may not be taken into account.

Effective Date

The effective dates of the provisions regarding deductions are described above under each provision.

2. Updating deduction rules for combination of plans (secs. 404(a)(7) and 4972 of the Code)

Present Law

Employer contributions to qualified retirement plans are deductible subject to certain limits.¹⁶⁴ In general, the deduction limit depends on the kind of plan.¹⁶⁵

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

Under EGTRRA, elective deferrals are not subject to the limits on deductions and are not taken into account in applying the limits to other employer contributions. The combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals.¹⁶⁶

Subject to certain exceptions, an employer that makes nondeductible contributions to a plan is subject to an excise tax equal to 10 percent of the amount of the nondeductible contributions for the year. Certain contributions to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded in determining the amount of nondeductible contributions for purposes of the excise tax. Contributions that are disregarded are the greater of (1) the amount of contributions not in excess of six percent of the compensation of the employees covered by the defined contribution plan, or (2) the amount of matching contributions.

Explanation of Provision

Under the bill, the overall limit on employer deductions for contributions to combinations of defined benefit and defined contribution plans applies to contributions to one or more defined contribution plans only to the extent that such contributions exceed six percent of compensation

¹⁶⁴ Code sec. 404.

¹⁶⁵ See the discussion under A., above, for a description of the deduction rules for defined benefit and defined contribution plans.

¹⁶⁶ Under the general EGTRRA sunset, this rule expires for plan years beginning after 2010.

otherwise paid or accrued during the taxable year to the beneficiaries under the plans. As under present law, for purposes of determining the excise tax on nondeductible contributions, matching contributions to a defined contribution plan that are nondeductible solely because of the overall deduction limit are disregarded.

Effective Date

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

B. Certain Pension Provisions Made Permanent

1. Permanency of EGTRRA pension and IRA provisions (Title X of EGTRRA)

Present Law

In general

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

Certain provisions contained in EGTRRA expire before the general sunset date of 2010.¹⁶⁷

List of affected provisions

Following is a list of the provisions affected by the general EGTRRA sunset.

Individual retirement arrangements (“IRAs”)

- Increases in the IRA contribution limits, including the ability to make catch-up contributions (secs. 219, 408, and 408A of the Code and sec. 601 of EGTRRA); and
- Rules relating to deemed IRAs under employer plans (sec. 408(q) of the Code and sec. 602 of EGTRRA).

Expanding coverage

- Increases in the limits on contributions, benefits, and compensation under qualified retirement plans, tax-sheltered annuities, and eligible deferred compensation plans (secs. 401(a)(17), 402(g), 408(p), 414(v), 415, and 457 of the Code and sec. 611 of EGTRRA);
- Application of prohibited transaction rules to plan loans of S corporation owners, partners, and sole proprietors (sec. 4975 of the Code and sec. 612 of EGTRRA);

¹⁶⁷ The saver’s credit (sec. 25B) expires at the end of 2006. Another provision of the bill makes the saver’s credit permanent.

- Modification of the top-heavy rules (sec. 416 of the Code and sec. 613 of EGTRRA);
- Elective deferrals not taken into account for purposes of deduction limits (sec. 404 of the Code and sec. 614 of EGTRRA);
- Repeal of coordination requirements for deferred compensation plans of state and local governments and tax-exempt organizations (sec. 457 of the Code and sec. 615 of EGTRRA);
- Modifications to deduction limits (sec. 404 of the Code and sec. 616 of EGTRRA);
- Option to treat elective deferrals as after-tax Roth contributions (sec. 402A of the Code and sec. 617 of EGTRRA);
- Credit for pension plan start-up costs (sec. 45E of the Code and sec. 619 of EGTRRA); and
- Certain nonresident aliens excluded in applying minimum coverage requirements (secs. 410(b)(3) and 861(a)(3) of the Code).

Enhancing fairness

- Catch-up contributions for individuals age 50 and older (sec. 414 of the Code and sec. 631 of EGTRRA);
- Equitable treatment for contributions of employees to defined contribution plans (secs. 403(b), 415, and 457 of the Code and sec. 632 of EGTRRA);
- Faster vesting of employer matching contributions (sec. 411 of the Code and sec. 633 of EGTRRA);
- Modifications to minimum distribution rules (sec. 401(a)(9) of the Code and sec. 634 of EGTRRA);
- Clarification of tax treatment of division of section 457 plan benefits upon divorce (secs. 414(p) and 457 of the Code and sec. 635 of EGTRRA);
- Provisions relating to hardship withdrawals (secs. 401(k) and 402 of the Code and sec. 636 of EGTRRA); and
- Waiver of tax on nondeductible contributions for domestic and similar workers (sec. 4972(c)(6) of the Code and sec. 637 of EGTRRA).

Increasing portability

- Rollovers of retirement plan and IRA distributions (secs. 401, 402, 403(b), 408, 457, and 3405 of the Code and secs. 641-644 of EGTRRA);
- Treatment of forms of distribution (sec. 411(d)(6) of the Code and sec. 645 of EGTRRA);
- Rationalization of restrictions on distributions (secs. 401(k), 403(b), and 457 of the Code and sec. 646 of EGTRRA):

- Purchase of service credit under governmental pension plans (secs. 403(b) and 457 of the Code and sec. 647 of EGTRRA);
- Employers may disregard rollovers for purposes of cash-out rules (sec. 411(a)(11) of the Code and sec. 648 of EGTRRA); and
- Minimum distribution and inclusion requirements for section 457 plans (sec. 457 of the Code and sec. 649 of EGTRRA).

Strengthening pension security and enforcement

- Phase in repeal of 160 percent of current liability funding limit; maximum deduction rules (secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code and secs. 651-652 of EGTRRA);
- Excise tax relief for sound pension funding (sec. 4972 of the Code and sec. 653 of EGTRRA);
- Modifications to section 415 limits for multiemployer plans (sec. 415 of the Code and sec. 654 of EGTRRA);
- Investment of employee contributions in 401(k) plans (sec. 655 of EGTRRA);
- Prohibited allocations of stock in an S corporation ESOP (secs. 409 and 4979A of the Code and sec. 656 of EGTRRA);
- Automatic rollovers of certain mandatory distributions (secs. 401(a)(31) and 402(f)(1) of the Code and sec. 657 of EGTRRA);
- Clarification of treatment of contributions to a multiemployer plan (sec. 446 of the Code and sec. 658 of EGTRRA); and
- Treatment of plan amendments reducing future benefit accruals (sec. 4980F of the Code and sec. 659 of EGTRRA).

Reducing regulatory burdens

- Modification of timing of plan valuations (sec. 412 of the Code and sec. 661 of EGTRRA);
- ESOP dividends may be reinvested without loss of dividend deduction (sec. 404 of the Code and sec. 662 of EGTRRA);
- Repeal transition rule relating to certain highly compensated employees (sec. 663 of EGTRRA);
- Treatment of employees of tax-exempt entities for purposes of nondiscrimination rules (secs. 410, 401(k), and 401(m) of the Code and sec. 664 of EGTRRA);
- Treatment of employer-provided retirement advice (sec. 132 of the Code and sec. 665 of EGTRRA); and
- Repeal of the multiple use test (sec. 401(m) of the Code and sec. 666 of EGTRRA).

Explanation of Provision

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

Effective Date

The provision is effective on the date of enactment.

2. Saver's credit made permanent (sec. 25B of the Code)

Present Law

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

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

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

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

Table 1.–Credit Rates for Saver’s Credit

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

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

Explanation of Provision

The provision makes the saver’s credit permanent.

The provision also provides that an individual may direct that the amount of any refund attributable to the saver’s credit be directly deposited by the Federal government into an applicable retirement plan, meaning an IRA, qualified retirement plan, section 403(b) annuity, or governmental section 457 plan designated by the individual (if the plan or other arrangement agrees to accept such direct deposits). In the case of a joint return, each spouse is entitled to designate an applicable retirement plan with respect to payments attributable to such spouse. The provision does not change the rules relating to the tax treatment of contributions to such plans or other arrangements.

Effective Date

The extension of the saver’s credit is effective on enactment. The provision relating to direct deposit of refunds relating to the saver’s credit is effective for taxable years beginning after December 31, 2006. (In addition, another provision of bill, described below, provides for indexing of the income limits on the saver’s credit.)

C. Improvements in Portability, Distribution, and Contribution Rules

1. Purchase of permissive service credit (secs. 403(b)(13), 415(n)(3), and 457(e)(17) of the Code)

Present Law

In general

Present law imposes limits on contributions and benefits under qualified plans.¹⁶⁸ The limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) a certain dollar amount (\$175,000 for 2006) or (2) 100 percent of the participant's average compensation for his or her high three years.

A qualified retirement plan maintained by a State or local government employer may provide that a participant may make after-tax employee contributions in order to purchase permissive service credit, subject to certain limits.¹⁶⁹

In the case of any repayment of contributions and earnings to a governmental plan with respect to an amount previously refunded upon a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State), any such repayment is not taken into account for purposes of the section 415 limits on contributions and benefits. Also, service credit obtained as a result of such a repayment is not considered permissive service credit for purposes of the section 415 limits.

Permissive service credit

Definition of permissive service credit

Permissive service credit means credit for a period of service recognized by the governmental plan which the participant has not received under the plan and which the employee receives only if the employee voluntarily contributes to the plan an amount (as determined by the plan) that does not exceed the amount necessary to fund the benefit attributable to the period of service and that is in addition to the regular employee contributions, if any, under the plan.

The IRS has ruled that credit is not permissive service credit where it is purchased to provide enhanced retirement benefits for a period of service already credited under the plan, as the enhanced benefit is treated as credit for service already received.¹⁷⁰

¹⁶⁸ Sec. 415.

¹⁶⁹ Sec. 415(n)(3).

¹⁷⁰ Priv. Ltr. Rul. 200229051 (April 26, 2002).

Nonqualified service

Service credit is not permissive service credit if more than five years of permissive service credit is purchased for nonqualified service or if nonqualified service is taken into account for an employee who has less than five years of participation under the plan. Nonqualified service is service other than service (1) as a Federal, State or local government employee, (2) as an employee of an association representing Federal, State or local government employees, (3) as an employee of an educational institution which provides elementary or secondary education, as determined under State law, or (4) for military service. Service under (1), (2) and (3) is nonqualified service if it enables a participant to receive a retirement benefit for the same service under more than one plan.

Trustee-to-trustee transfers to purchase permissive service credit

Under EGTRRA, a participant is not required to include in gross income a direct trustee-to-trustee transfer to a governmental defined benefit plan from a section 403(b) annuity or a section 457 plan if the transferred amount is used (1) to purchase permissive service credit under the plan, or (2) to repay contributions and earnings with respect to an amount previously refunded under a forfeiture of service credit under the plan (or another plan maintained by a State or local government employer within the same State).¹⁷¹

Explanation of Provision

Permissive service credit

The provision modifies the definition of permissive service credit by providing that permissive service credit means service credit which relates to benefits to which the participant is not otherwise entitled under such governmental plan, rather than service credit which such participant has not received under the plan. Credit qualifies as permissive service credit if it is purchased to provide an increased benefit for a period of service already credited under the plan (e.g., if a lower level of benefit is converted to a higher benefit level otherwise offered under the same plan) as long as it relates to benefits to which the participant is not otherwise entitled.

The provision allows participants to purchase credit for periods regardless of whether service is performed, subject to the limits on nonqualified service.

Under the provision, service as an employee of an educational organization providing elementary or secondary education can be determined under the law of the jurisdiction in which the service was performed. Thus, for example, permissive service credit can be granted for time spent teaching outside of the United States without being considered nonqualified service credit.

¹⁷¹ Secs. 403(b)(13) and 457(e)(17).

Trustee-to-trustee transfers to purchase permissive service credit

The provision provides that the limits regarding nonqualified service are not applicable in determining whether a trustee-to-trustee transfer from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan is for the purchase of permissive service credit. Thus, failure of the transferee plan to satisfy the limits does not cause the transferred amounts to be included in the participant's income. As under present law, the transferee plan must satisfy the limits in providing permissive service credit as a result of the transfer.

The provision provides that trustee-to-trustee transfers under sections 457(e)(17) and 403(b)(13) may be made regardless of whether the transfer is made between plans maintained by the same employer. The provision also provides that amounts transferred from a section 403(b) annuity or a section 457 plan to a governmental defined benefit plan to purchase permissive service credit are subject to the distribution rules applicable under the Internal Revenue Code to the defined benefit plan.

Effective Date

The provision is generally effective as if included in the amendments made by section 1526 of the Taxpayer Relief Act of 1997, except that the provision regarding trustee-to-trustee transfers is effective as if included in the amendments made by section 647 of the Economic Growth and Tax Relief Reconciliation Act of 2001.

2. Rollover of after-tax amounts in annuity contracts (sec. 402(c)(2) of the Code)

Present Law

Employee after-tax contributions may be rolled over from a tax-qualified retirement plan into another tax-qualified retirement plan, if the plan to which the rollover is made is a defined contribution plan, the rollover is accomplished through a direct rollover, and the plan to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions can also be rolled over from a tax-sheltered annuity (a "section 403(b) annuity") to another tax-sheltered annuity if the rollover is a direct rollover, and the annuity to which the rollover is made provides for separate accounting for such contributions (and earnings thereon). After-tax contributions may also be rolled over to an IRA. If the rollover is to an IRA, the rollover need not be a direct rollover and the IRA owner has the responsibility to keep track of the amount of after-tax contributions.¹⁷²

Explanation of Provision

The provision allows after-tax contributions to be rolled over from a qualified retirement plan to another qualified retirement plan (either a defined contribution or a defined benefit plan) or to a tax-sheltered annuity. As under present law, the rollover must be a direct rollover, and

¹⁷² Sec. 402(c)(2); IRS Notice 2002-3, 2002-2 I.R.B. 289.

the plan to which the rollover is made must separately account for after-tax contributions (and earnings thereon).

Effective Date

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

3. Application of minimum distribution rules to governmental plans

Present Law

Minimum distribution rules apply to tax-favored retirement arrangements, including governmental plans. In general, under these rules, distribution of minimum benefits must begin no later than the required beginning date. Minimum distribution rules also apply to benefits payable with respect to a plan participant who has died. Failure to comply with the minimum distribution rules results in an excise tax imposed on the plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived in certain cases.

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

The required beginning date generally is April 1 of the calendar year following the later of (1) the calendar year in which the participant attains age 70½ or (2) the calendar year in which the participant retires.

The minimum distribution rules also apply to distributions to beneficiaries of deceased participants. In general, if the participant dies after minimum distributions have begun, the remaining interest must be distributed at least as rapidly as under the minimum distribution method being used as of the date of death. If the participant dies before minimum distributions have begun, then the entire remaining interest must generally be distributed within five years of the participant's death. The five-year rule does not apply if distributions begin within one year of the participant's death and are payable over the life of a designated beneficiary or over the life expectancy of a designated beneficiary. A surviving spouse beneficiary is not required to begin distributions until the date the deceased participant would have attained age 70½. In addition, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, the minimum distribution rules apply separately to the surviving spouse.

Explanation of Provision

The provision directs the Secretary of the Treasury to issue regulations under which a governmental plan is treated as complying with the minimum distribution requirements, for all years to which such requirements apply, if the plan complies with a reasonable, good faith interpretation of the statutory requirements. It is intended that the regulations apply for periods before the date of enactment.

Effective Date

The provision is effective on the date of enactment.

4. Allow direct rollovers from retirement plans to Roth IRAs (sec. 408A(e) of the Code)

Present Law

IRAs in general

There are two general types of individual retirement arrangements (“IRAs”): traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs.

Traditional IRAs

An individual may make deductible contributions to an IRA up to the lesser of a dollar limit (generally \$4,000 for 2006)¹⁷³ or the individual’s compensation if neither the individual nor the individual’s spouse is an active participant in an employer-sponsored retirement plan.¹⁷⁴ If the individual (or the individual’s spouse) is an active participant in an employer-sponsored retirement plan, the deduction limit is phased out for taxpayers with adjusted gross income (“AGI”) over certain levels for the taxable year. A different, higher, income phaseout applies in the case of an individual who is not an active participant in an employer sponsored plan but whose spouse is.

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

Amounts held in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal is a return of nondeductible contributions). Includible amounts withdrawn prior to attainment of age 59½ are subject to an additional 10-percent early

¹⁷³ The dollar limit is scheduled to increase until it is \$5,000 in 2008-2010. Individuals age 50 and older may make additional, catch-up contributions.

¹⁷⁴ In the case of a married couple, deductible IRA contributions of up to the dollar limit can be made for each spouse (including, for example, a homemaker who does not work outside the home), if the combined compensation of both spouses is at least equal to the contributed amount.

withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, or is used for certain specified purposes.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contributions that can be made to all of an individual's IRAs (both traditional and Roth) cannot exceed the maximum deductible IRA contribution limit. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with income above certain levels.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) which is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

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

Rollover contributions

If certain requirements are satisfied, a participant in a tax-qualified retirement plan, a tax-sheltered annuity (sec. 403(b)), or a governmental section 457 plan may roll over distributions from the plan or annuity into a traditional IRA. Distributions from such plans may not be rolled over into a Roth IRA.

Taxpayers with modified AGI of \$100,000 or less generally may roll over amounts in a traditional IRA into a Roth IRA. The amount rolled over is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply. Married taxpayers who file separate returns cannot roll over amounts in a traditional IRA into a Roth IRA. Amounts that have been distributed from a tax-qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan may be rolled over into a traditional IRA, and then rolled over from the traditional IRA into a Roth IRA.

Explanation of Provision

The provision allows distributions from tax-qualified retirement plans, tax-sheltered annuities, and governmental 457 plans to be rolled over directly from such plan into a Roth IRA, subject to the present law rules that apply to rollovers from a traditional IRA into a Roth IRA. For example, a rollover from a tax-qualified retirement plan into a Roth IRA is includible in gross income (except to the extent it represents a return of after-tax contributions), and the 10-percent early distribution tax does not apply. Similarly, an individual with AGI of \$100,000 or more could not roll over amounts from a tax-qualified retirement plan directly into a Roth IRA.

Effective Date

The provision is effective for distributions made after December 31, 2007.

5. Eligibility for participation in eligible deferred compensation plans (sec. 457 of the Code)

Present Law

A section 457 plan is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. In some cases, different rules apply under section 457 to governmental plans and plans of tax-exempt employers.

Amounts deferred under an eligible deferred compensation plan of a non-governmental tax-exempt organization are includible in gross income for the year in which amounts are paid or made available. Under present law, if the amount payable to a participant does not exceed \$5,000, a plan may allow a distribution up to \$5,000 without such amount being treated as made available if the distribution can be made only if no amount has been deferred under the plan by the participant during the two-year period ending on the date of the distribution and there has been no prior distribution under the plan. Prior to the Small Business Job Protection Act of 1996, under former section 457(e)(9), benefits were not treated as made available because a participant could elect to receive a lump sum payable after separation from service and within 60 days of the election if (1) the total amount payable under the plan did not exceed \$3,500 and (2) no additional amounts could be deferred under the plan.

Explanation of Provision

Under the provision, an individual is not precluded from participating in an eligible deferred compensation plan by reason of having received a distribution under section 457(e)(9) as in effect before the Small Business Job Protection Act of 1996.

Effective Date

The provision is effective on the date of enactment.

6. Modifications of rules governing hardships and unforeseen financial emergencies

Present Law

Distributions from a qualified cash or deferred arrangement (a “section 401(k) plan”), a tax-shelter annuity, section 457 plan, or nonqualified deferred compensation plan subject to section 409A may not be made prior to the occurrence of one or more specified events. In the case of a section 401(k) plan or tax-sheltered annuity, one event upon which distribution is permitted is the case of a hardship. Similarly, distributions from section 457 plans and nonqualified deferred compensation plans subject to section 409A may be made in the case of an unforeseeable emergency. Under regulations, a hardship or unforeseeable emergency includes a hardship or unforeseeable emergency of a participant’s spouse or dependent.

Explanation of Provision

The provision directs the Secretary of the Treasury to revise the rules for determining whether a participant has had a hardship or unforeseeable emergency to provide that if an event would constitute a hardship or unforeseeable emergency under the plan if it occurred with respect to the participant's spouse or dependent, such event shall, to the extent permitted under the plan, constitute a hardship or unforeseeable emergency if it occurs with respect to a beneficiary under the plan. The provision requires that the revised rules be issued within 180 days after the date of enactment.

Effective Date

The provision is effective on the date of enactment.

7. Treatment of distributions to individuals called to active duty for at least 179 days (sec. 72(t) of the Code)

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Certain amounts held in a qualified cash or deferred arrangement (a "401(k) plan") or in a tax-sheltered annuity (a "403(b) annuity") may not be distributed before severance from employment, age 59½, death, disability, or financial hardship of the employee.

Explanation of Provision

Under the provision, the 10-percent early withdrawal tax does not apply to a qualified reservist distribution. A qualified reservist distribution is a distribution (1) from an IRA or attributable to elective deferrals under a 401(k) plan, 403(b) annuity, or certain similar arrangements, (2) made to an individual who (by reason of being a member of a reserve component as defined in section 101 of title 37 of the U.S. Code) was ordered or called to active duty for a period in excess of 179 days or for an indefinite period, and (3) that is made during the period beginning on the date of such order or call to duty and ending at the close of the active duty period. A 401(k) plan or 403(b) annuity does not violate the distribution restrictions applicable to such plans by reason of making a qualified reservist distribution.

An individual who receives a qualified reservist distribution may, at any time during the two-year period beginning on the day after the end of the active duty period, make one or more contributions to an IRA of such individual in an aggregate amount not to exceed the amount of such distribution. The dollar limitations otherwise applicable to contributions to IRAs do not

apply to any contribution made pursuant to the provision. No deduction is allowed for any contribution made under the provision.

This provision applies to individuals ordered or called to active duty after September 11, 2001, and before December 31, 2007. The two-year period for making recontributions of qualified reservist distributions does not end before the date that is two years after the date of enactment.

Effective Date

The provision applies to distributions after September 11, 2001. If refund or credit of any overpayment of tax resulting from the provision would be prevented at any time before the close of the one-year period beginning on the date of the enactment by the operation of any law or rule of law (including res judicata), such refund or credit may nevertheless be made or allowed if claim therefor is filed before the close of such period.

8. Inapplicability of 10-percent additional tax on early distributions of pension plans of public safety employees (sec. 72(t) of the Code)

Present Law

Under present law, a taxpayer who receives a distribution from a qualified retirement plan prior to age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception to the tax applies. Among other exceptions, the early distribution tax does not apply to distributions made to an employee who separates from service after age 55, or to distributions that are part of a series of substantially equal periodic payments made for the life (or life expectancy) of the employee or the joint lives (or life expectancies) of the employee and his or her beneficiary.

Explanation of Provision

Under the provision, the 10-percent early withdrawal tax does not apply to distributions from a governmental defined benefit pension plan to a qualified public safety employee who separates from service after age 50. A qualified public safety employee is an employee of a State or political subdivision of a State if the employee provides police protection, firefighting services, or emergency medical services for any area within the jurisdiction of such State or political subdivision.

Effective Date

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

9. Rollovers by nonspouse beneficiaries (sec. 402 of the Code)

Present Law

Tax-free rollovers

Under present law, a distribution from a qualified retirement plan, a tax-sheltered annuity (“section 403(b) annuity”), an eligible deferred compensation plan of a State or local government employer (a “governmental section 457 plan”), or an individual retirement arrangement (an “IRA”) generally is included in income for the year distributed. However, eligible rollover distributions may be rolled over tax free within 60 days to another plan, annuity, or IRA.¹⁷⁵

In general, an eligible rollover distribution includes any distribution to the plan participant or IRA owner other than certain periodic distributions, minimum required distributions, and distributions made on account of hardship.¹⁷⁶ Distributions to a participant from a qualified retirement plan, a tax-sheltered annuity, or a governmental section 457 plan generally can be rolled over to any of such plans or an IRA.¹⁷⁷ Similarly, distributions from an IRA to the IRA owner generally are permitted to be rolled over into a qualified retirement plan, a tax-sheltered annuity, a governmental section 457 plan, or another IRA.

Similar rollovers are permitted in the case of a distribution to the surviving spouse of the plan participant or IRA owner, but not to other persons.

If an individual inherits an IRA from the individual’s deceased spouse, the IRA may be treated as the IRA of the surviving spouse. This treatment does not apply to IRAs inherited from someone other than the deceased spouse. In such cases, the IRA is not treated as the IRA of the beneficiary. Thus, for example, the beneficiary may not make contributions to the IRA and cannot roll over any amounts out of the inherited IRA. Like the original IRA owner, no amount is generally included in income until distributions are made from the IRA. Distributions from the inherited IRA must be made under the rules that apply to distributions to beneficiaries, as described below.

Minimum distribution rules

Minimum distribution rules apply to tax-favored retirement arrangements. In the case of distributions prior to the death of the participant, distributions generally must begin by the April

¹⁷⁵ The IRS has the authority to waive the 60-day requirement if failure to waive the requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual. Sec. 402(c)(3)(B).

¹⁷⁶ Sec. 402(c)(4). Certain other distributions also are not eligible rollover distributions, e.g., corrective distributions of elective deferrals in excess of the elective deferral limits and loans that are treated as deemed distributions.

¹⁷⁷ Some restrictions or special rules may apply to certain distributions. For example, after-tax amounts distributed from a plan can be rolled over only to a plan of the same type or to an IRA.

1 of the calendar year following the later of the calendar year in which the participant (1) attains age 70½ or (2) retires.¹⁷⁸ The minimum distribution rules also apply to distributions following the death of the participant. If minimum distributions have begun prior to the participant's death, the remaining interest generally must be distributed at least as rapidly as under the minimum distribution method being used prior to the date of death. If the participant dies before minimum distributions have begun, then either (1) the entire remaining interest must be distributed within five years of the death, or (2) distributions must begin within one year of the death over the life (or life expectancy) of the designated beneficiary. A beneficiary who is the surviving spouse of the participant is not required to begin distributions until the date the deceased participant would have attained age 70½. Alternatively, if the surviving spouse makes a rollover from the plan into a plan or IRA of his or her own, minimum distributions generally would not need to begin until the surviving spouse attains age 70½.

Explanation of Provision

The provision provides that benefits of a beneficiary other than a surviving spouse may be transferred directly to an IRA. The IRA is treated as an inherited IRA of the nonspouse beneficiary. Thus, for example, distributions from the inherited IRA are subject to the distribution rules applicable to beneficiaries. The provision applies to amounts payable to a beneficiary under a qualified retirement plan, governmental section 457 plan, or a tax-sheltered annuity. To the extent provided by the Secretary, the provision applies to benefits payable to a trust maintained for a designated beneficiary to the same extent it applies to the beneficiary.

Effective Date

The provision is effective for distributions after December 31, 2006.

10. Direct deposit of tax refunds in an IRA

Present Law

Under current IRS procedures, a taxpayer may direct that his or her tax refund be deposited into a checking or savings account with a bank or other financial institution (such as a mutual fund, brokerage firm, or credit union) rather than having the refund sent to the taxpayer in the form of a check.

Explanation of Provision

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

¹⁷⁸ In the case of five-percent owners and distributions from an IRA, distributions must begin by the April 1 of the calendar year following the year in which the individual attains age 70½.

Effective Date

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

11. Additional IRA contributions for certain employees (secs. 25B and 219 of the Code)

Present Law

Under present law, favored tax treatment applies to qualified retirement plans maintained by employers and to individual retirement arrangements (“IRAs”).

Qualified defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a “section 401(k) plan”), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions. Matching contributions are sometimes made in the form of employer stock.

Under present law, an individual may generally make contributions to an IRA for a taxable year up to the lesser of a certain dollar amount or the individual’s compensation. The maximum annual dollar limit on IRA contributions to IRAs is \$4,000 for 2005-2007 and \$5,000 for 2008, with indexing thereafter. Individuals who have attained age 50 may make additional “catch-up” contributions to an IRA for a taxable year of up to \$500 for 2005 and \$1,000 for 2006 and thereafter.¹⁷⁹

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions (“saver’s” credit). The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income (“AGI”) of the taxpayer. Taxpayers filing joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or over, other than individuals who are full-time students or claimed as a dependent on another taxpayer’s return. The credit is available with respect to contributions to various types of retirement savings arrangements, including contributions to a

¹⁷⁹ These IRA limits were enacted as part of the Economic Growth and Tax Relief Reconciliation Act of 2001 (“EGTRRA”), Pub. L. No. 107-16. The provisions of EGTRRA generally do not apply for years beginning after December 31, 2010.

traditional or Roth IRA. The saver's credit does not apply to taxable years beginning after December 31, 2006.

Explanation of Provision

Under the provision, an applicable individual may elect to make additional IRA contributions of up to \$3,000 per year for 2006-2009. An applicable individual must have been a participant in a section 401(k) plan under which the employer matched at least 50 percent of the employee's contributions to the plan with stock of the employer. In addition, in a taxable year preceding the taxable year of an additional contribution: (1) the employer (or any controlling corporation of the employer) must have been a debtor in a bankruptcy case, and (2) the employer or any other person must have been subject to an indictment or conviction resulting from business transactions related to the bankruptcy. The individual must also have been a participant in the section 401(k) plan on the date six months before the bankruptcy case was filed. An applicable individual who elects to make these additional IRA contributions is not permitted to make IRA catch-up contributions that apply to individuals age 50 and older.

Effective Date

The provision is effective for taxable years beginning after December 31, 2006, and before January 1, 2010.

12. Special rule for computing high-three average compensation for benefit limitation purposes (sec. 415(b)(3) of the Code)

Present Law

Annual benefits payable to a participant under a defined benefit pension plan generally may not exceed the lesser of (1) 100 percent of average compensation for the participant's high three years, or (2) \$175,000 (for 2006). The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan. The compensation limit is reduced proportionately for individuals with less than 10 years of service.

For purposes of determining average compensation for a participant's high three years, the high three years are the period of consecutive calendar years (not more than three) during which the participant was both an active participant in the plan and had the greatest aggregate compensation from the employer.

Explanation of Provision

Under the bill, for purposes of determining average compensation for a participant's high three years, the high three years are the period of consecutive calendar years (not more than three) during which the participant had the greatest aggregate compensation from the employer.

Effective Date

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

13. Inflation indexing of gross income limitations on certain retirement savings incentives (secs. 25A and 219 of the Code)

Present Law

Saver's credit

Present law provides a temporary nonrefundable tax credit for eligible taxpayers for qualified retirement savings contributions. The maximum annual contribution eligible for the credit is \$2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Joint returns with AGI of \$50,000 or less, head of household returns of \$37,500 or less, and single returns of \$25,000 or less are eligible for the credit. The AGI limits applicable to single taxpayers apply to married taxpayers filing separate returns. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. The credit offsets minimum tax liability as well as regular tax liability. The credit is available to individuals who are 18 or older, other than individuals who are full-time students or claimed as a dependent on another taxpayer's return.

Under present law, the saver's credit expires after 2006.

Individual retirement arrangements

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs,¹⁸⁰ to which both deductible and nondeductible contributions may be made,¹⁸¹ and Roth IRAs.¹⁸²

The maximum annual deductible and nondeductible contributions that can be made to a traditional IRA and the maximum contribution that can be made to a Roth IRA by or on behalf of an individual varies depending on the particular circumstances, including the individual's income. However, the contribution limits for IRAs are coordinated so that the maximum annual contribution that can be made to all of an individual's IRAs is the lesser of a certain dollar amount (\$4,000 for 2006) or the individual's compensation. In the case of a married couple, contributions can be made up to the dollar limit for each spouse if the combined compensation of the spouses is at least equal to the contributed amount. An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to an IRA. For this purpose, the dollar limit is increased by a certain dollar amount (\$1,000 for 2006).¹⁸³

¹⁸⁰ Sec. 408.

¹⁸¹ Sec. 219.

¹⁸² Sec. 408A.

¹⁸³ Under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA"), the dollar limit on IRA contributions increases to \$5,000 in 2008, with indexing for inflation thereafter. The

Traditional IRAs

An individual may make deductible contributions to a traditional IRA up to the IRA contribution limit if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. If an individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the deduction is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out ranges are: (1) for single taxpayers, \$50,000 to \$60,000; (2) for married taxpayers filing joint returns, \$75,000 to \$85,000 for 2006 and \$80,000 to \$100,000 for years after 2006; and (3) for married taxpayers filing separate returns, \$0 to \$10,000. If an individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the deduction is phased out for taxpayers with adjusted gross income between \$150,000 and \$160,000.

To the extent an individual cannot or does not make deductible contributions to an IRA or contributions to a Roth IRA, the individual may make nondeductible contributions to a traditional IRA, subject to the same limits as deductible contributions. An individual who has attained age 50 before the end of the taxable year may also make nondeductible catch-up contributions to an IRA.

Amounts held in a traditional IRA are includible in income when withdrawn, except to the extent the withdrawal is a return of nondeductible contributions. Withdrawals from an IRA before age 70½, death, or disability are subject to an additional 10-percent tax unless an exception applies.¹⁸⁴

Roth IRAs

Individuals with adjusted gross income below certain levels may make nondeductible contributions to a Roth IRA, subject to the overall limit on IRA contributions described above. The maximum annual contribution that can be made to a Roth IRA is phased out for taxpayers with adjusted gross income over certain levels for the taxable year. The adjusted gross income phase-out ranges are: (1) for single taxpayers, \$95,000 to \$110,000; (2) for married taxpayers filing joint returns, \$150,000 to \$160,000; and (3) for married taxpayers filing separate returns, \$0 to \$10,000.

Taxpayers generally may convert a traditional IRA into a Roth IRA, except for married taxpayers filing separate returns. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply.

provisions of EGTRRA generally do not apply for years beginning after December 31, 2010. As a result, the dollar limit on annual IRA contributions is \$2,000 for years after 2010, and catch-ups contributions are not permitted.

¹⁸⁴ Sec. 72(t).

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) is made after attainment of age 59½, on account of death or disability, or is made for first-time homebuyer expenses of up to \$10,000.

Distributions from a Roth IRA that are not qualified distributions are includible in income to the extent attributable to earnings. The amount includible in income is also subject to the 10-percent early withdrawal tax described above.

Explanation of Provision

The bill indexes the income limits applicable to the saver's credit beginning in 2007. (Another provision of the bill, described above, permanently extends the saver's credit.) Indexed amounts are rounded to the nearest multiple of \$500. Under the indexed income limits, as under present law, the income limits for single taxpayers is one-half that for married taxpayers filing a joint return and the limits for heads of household are three-fourths that for married taxpayers filing a joint return.

The bill also indexes the income limits for IRA contributions beginning in 2007. The indexing applies to the income limits for deductible contributions for active participants in an employer-sponsored plan,¹⁸⁵ the income limits for deductible contributions if the individual is not an active participant but the individual's spouse is, and the income limits for Roth IRA contributions. Indexed amounts are rounded to the nearest multiple of \$1,000. The provision does not affect the phase-out ranges under present law. Thus, for example, in the case of an active participant in an employer-sponsored plan, the phase-out range is \$20,000 in the case of a married taxpayer filing a joint return and \$10,000 in the case of an individual taxpayer.

Effective Date

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

¹⁸⁵ Under the bill, for 2007, the lower end of the income phase out for active participants filing a joint return is \$80,000 as adjusted to reflect inflation.

D. Health and Medical Benefits

1. Ability to use excess pension assets for future retiree health benefits and collectively bargained retiree health benefits (sec. 420 of the Code)

Present Law

Transfer of pension assets

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan (“retiree medical accounts”). A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.¹⁸⁶ A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. A qualified transfer may not be made from a multiemployer plan. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan’s assets¹⁸⁷ over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan’s current liability.¹⁸⁸ In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon). In

¹⁸⁶ Sec. 420.

¹⁸⁷ The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

¹⁸⁸ In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan’s assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan’s current liability (for 2003), or (2) 125 percent of the plan’s current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

addition, no deduction is allowed for amounts paid other than from transferred funds for qualified current retiree health liabilities to the extent such amounts are not greater than the excess of (1) the amount transferred (and any income thereon), over (2) qualified current retiree health liabilities paid out of transferred assets (and any income thereon). An employer may not contribute any amount to a health benefits account or welfare benefit fund with respect to qualified current retiree health liabilities for which transferred assets are required to be used.

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order for a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, ERISA provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.¹⁸⁹

Deductions for contributions

Deductions for contributions to qualified retirement plans are subject to certain limits. Deductions for contributions to funded welfare benefit plans are generally also subject to limits, including limits on the amount that may be contributed to an account to fund the expected cost of retiree medical benefits for future years. The limit on the amount that may be contributed to an account to fund the expected cost of retiree medical benefits for future years does not apply to a separate fund established under a collective bargaining agreement.

¹⁸⁹ ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

Explanation of Provision

In general

If certain requirements are satisfied, the bill permits transfers of excess pension assets under a single-employer plan to retiree medical accounts to fund the expected cost of retiree medical benefits for the current and future years (a “qualified future transfer”) and also allows such transfers in the case of benefits provided under a collective bargaining agreement (a “collectively bargained transfer”). Transfers must be made for at least a two-year period. An employer can elect to make a qualified future transfer or a collectively bargained transfer rather than a qualified transfer. A qualified future transfer or collectively bargained transfer must meet the requirements applicable to qualified transfers, except that the provision modifies the rules relating to (1) the determination of excess pension assets; (2) the limitation on the amount transferred; and (3) the minimum cost requirement. Additional requirements apply in the case of collectively bargained transfer.

The general sunset applicable to qualified transfer applies (i.e., transfers can be made only before January 1, 2014).

Rule applicable to qualified future transfers and collectively bargained transfers

Qualified future transfers and collectively bargained transfers can be made to the extent that plan assets exceed the greater of (1) accrued liability, or (2) 120 percent of current liability.¹⁹⁰ The provision requires that, during the transfer period, the plan’s funded status must be maintained at the minimum level required to make transfers. If the minimum level is not maintained, the employer must make contributions to the plan to meet the minimum level or an amount required to meet the minimum level must be transferred from the health benefits account. The transfer period is the period not to exceed a total of ten consecutive taxable years beginning with the taxable year of the transfer. As previously discussed, the period must be not less than two consecutive years.

A limit applies on the amount that can be transferred. In the case of a qualified future transfer, the amount of excess pension assets that may be transferred is limited to the sum of (1) the amount that is reasonably estimated to be the amount the employer will pay out of the account during the taxable year of the transfer for current retiree health liabilities, and (2) the sum of the qualified current retiree health liabilities which the plan reasonably estimates, in accordance with guidance issued by the Secretary, will be incurred for each additional year in the transfer period. The amount that can be transferred under a collectively bargained transfer cannot exceed the amount which is reasonably estimated, in accordance with the provisions of the collective bargaining agreement and generally accepted accounting principles, to be the amount the employer maintaining the plan will pay out of such account during the collectively bargained cost maintenance period for collectively bargained retiree health liabilities.

¹⁹⁰ The single-employer plan funding concepts are updated after 2007 to reflect the changes to the single-employer plan funding rules under the bill.

The provision also modifies the minimum cost requirement which requires retiree medical benefits to be maintained at a certain level. In the case of a qualified future transfer, the minimum cost requirement will be satisfied if, during the transfer period and the four subsequent years, the annual average amount of employer costs is not less than applicable employer cost determined with respect to the transfer. An employer may elect to meet this minimum cost requirement by meeting the requirements as in effect before the amendments made by section 535 of the Tax Relief Extension Act of 1999 for each year during the transfer period and the four subsequent years. In the case of a collectively bargained transfer, the minimum cost requirements is satisfied if each collectively bargained group health plan under which collectively bargained health benefits are provided provides that the collectively bargained employer cost for each table year during the collectively bargained cost maintenance period is not less than the amount specified by the collective bargaining agreement. The collectively bargained employer cost is the average cost per covered individual of providing collectively bargained retiree health benefits as determined in accordance with the applicable collective bargaining agreement. Thus, retiree medical benefits must be provided at the level determined under the collective bargaining agreement for the shorter of (1) the remaining lifetime of each covered retiree (and any covered spouse and dependent), or (2) the period of coverage provided under the collectively bargained health plan for such covered retiree (and any covered spouse and dependent).

Additional requirements for collectively bargained transfers

As previously discussed, the bill imposes certain additional requirements in the case of a collectively bargained transfer. Collectively bargained transfers can be made only if (1) for the employer's taxable year ending in 2005, medical benefits are provided to retirees (and spouses and dependents) under all the employer's benefit plans, and (2) the aggregate cost of benefits for such year is at least five percent of the employer's gross receipts. The provision also applies to successors of such employers. Before a collectively bargained transfer, the employer must designate in writing to each employee organization that is a party to the collective bargaining agreement that the transfer is a collectively bargained transfer.

Collectively bargained retiree health liabilities means the present value, as of the beginning of a taxable year and determined in accordance with the applicable collective bargaining agreement, of all collectively bargained health benefits (including administrative expenses) for such taxable year and all subsequent taxable years during the collectively bargained cost maintenance period (with the exclusion of certain key employees) reduced by the value of assets in all health benefits accounts or welfare benefit funds set aside to pay for the collectively bargained retiree health liabilities. Collectively bargained health benefits are health benefits or coverage provided to retired employees who, immediately before the collectively bargained transfer, are entitled to receive such benefits upon retirement and who are entitled to pension benefits under the plan (and their spouses and dependents). If specified by the provisions of the collective bargaining agreement, collectively bargained health benefits also include active employees who, following their retirement, are entitled to receive such benefits and who are entitled to pension benefits under the plan (and their spouse and dependents).

Assets transferred in a collectively bargained transfer can be used to pay collectively bargained retiree health liabilities (other than liabilities of certain key employees not taken into

account) for the taxable year of the transfer and for any subsequent taxable year during the collectively bargained cost maintenance period. The collectively bargained cost maintenance period (with respect to a retiree) is the shorter of (1) the remaining lifetime of the covered retiree (and any covered spouse and dependents) or (2) the period of coverage provided by the collectively bargained health plan with respect to such covered retiree (and any covered spouse and dependents).

The limit on deductions in the case of certain amounts paid for qualified current retiree health liabilities other than from the health benefits account does not apply in the case of a collectively bargained transfer.

An employer may contribute additional amounts to a health benefits account or welfare benefit fund with respect to collectively bargained health liabilities for which transferred assets are required to be used. The deductibility of such contributions are subject to the limits that otherwise apply to a welfare benefit fund under a collective bargaining agreements without regard to whether such contributions are made to a health benefits account or a welfare benefit fund and without regard to the limits on deductions for contributions to qualified retirement plans (under Code section 404). The Secretary of the Treasury is directed to provide rules to prevent duplicate deductions for the same contributions or for duplicate contributions to fund the same benefits.

Effective Date

The provision is effective for transfers after the date of enactment.

2. Transfer of excess pension assets to multiemployer health plans (sec. 420 of the Code)

Present Law

Defined benefit plan assets generally may not revert to an employer prior to termination of the plan and satisfaction of all plan liabilities. In addition, a reversion may occur only if the plan so provides. A reversion prior to plan termination may constitute a prohibited transaction and may result in plan disqualification. Any assets that revert to the employer upon plan termination are includible in the gross income of the employer and subject to an excise tax. The excise tax rate is 20 percent if the employer maintains a replacement plan or makes certain benefit increases in connection with the termination; if not, the excise tax rate is 50 percent. Upon plan termination, the accrued benefits of all plan participants are required to be 100-percent vested.

A pension plan may provide medical benefits to retired employees through a separate account that is part of such plan. A qualified transfer of excess assets of a defined benefit plan to such a separate account within the plan may be made in order to fund retiree health benefits.¹⁹¹ A qualified transfer does not result in plan disqualification, is not a prohibited transaction, and is not treated as a reversion. Thus, transferred assets are not includible in the gross income of the

¹⁹¹ Sec. 420.

employer and are not subject to the excise tax on reversions. No more than one qualified transfer may be made in any taxable year. A qualified transfer may not be made from a multiemployer plan. No qualified transfer may be made after December 31, 2013.

Excess assets generally means the excess, if any, of the value of the plan's assets¹⁹² over the greater of (1) the accrued liability under the plan (including normal cost) or (2) 125 percent of the plan's current liability.¹⁹³ In addition, excess assets transferred in a qualified transfer may not exceed the amount reasonably estimated to be the amount that the employer will pay out of such account during the taxable year of the transfer for qualified current retiree health liabilities. No deduction is allowed to the employer for (1) a qualified transfer or (2) the payment of qualified current retiree health liabilities out of transferred funds (and any income thereon).

Transferred assets (and any income thereon) must be used to pay qualified current retiree health liabilities for the taxable year of the transfer. Transferred amounts generally must benefit pension plan participants, other than key employees, who are entitled upon retirement to receive retiree medical benefits through the separate account. Retiree health benefits of key employees may not be paid out of transferred assets.

Amounts not used to pay qualified current retiree health liabilities for the taxable year of the transfer are to be returned to the general assets of the plan. These amounts are not includible in the gross income of the employer, but are treated as an employer reversion and are subject to a 20-percent excise tax.

In order for the transfer to be qualified, accrued retirement benefits under the pension plan generally must be 100-percent vested as if the plan terminated immediately before the transfer (or in the case of a participant who separated in the one-year period ending on the date of the transfer, immediately before the separation).

In order to a transfer to be qualified, the employer generally must maintain retiree health benefits at the same level for the taxable year of the transfer and the following four years.

In addition, ERISA provides that, at least 60 days before the date of a qualified transfer, the employer must notify the Secretary of Labor, the Secretary of the Treasury, employee representatives, and the plan administrator of the transfer, and the plan administrator must notify each plan participant and beneficiary of the transfer.¹⁹⁴

¹⁹² The value of plan assets for this purpose is the lesser of fair market value or actuarial value.

¹⁹³ In the case of plan years beginning before January 1, 2004, excess assets generally means the excess, if any, of the value of the plan's assets over the greater of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 170 percent of the plan's current liability (for 2003), or (2) 125 percent of the plan's current liability. The current liability full funding limit was repealed for years beginning after 2003. Under the general sunset provision of EGTRRA, the limit is reinstated for years after 2010.

¹⁹⁴ ERISA sec. 101(e). ERISA also provides that a qualified transfer is not a prohibited transaction under ERISA or a prohibited reversion.

Under present law, special deduction rules apply to a multiemployer defined benefit plan established before January 1, 1954, under an agreement between the Federal government and employee representatives in a certain industry.¹⁹⁵

Explanation of Provision

The bill allows qualified transfers of excess defined benefit plan assets to be made by multiemployer defined benefit plans.

Effective Date

The provision is effective for transfer made in taxable years beginning after December 31, 2006.

3. Allowance of reserve for medical benefits of plans sponsored by bona fide associations (sec. 419A of the Code)

Present Law

Under present law, deductions for contributions to funded welfare benefit plans are generally subject to limits, including limits on the amount that may be contributed to an account to fund medical benefits (other than retiree medical benefits) for future years. Deductions for contributions to a welfare benefit fund are limited to the fund's qualified cost for the taxable year. The qualified cost is the sum of (1) the qualified direct cost for the taxable year, and (2) permissible additions to a qualified asset account.

The qualified direct costs are the amount which would have been allowable as a deduction to the employer with respect to the benefits provided during the taxable year if the benefits were provided directly by the employer and the employer used the cash receipts and disbursements method of accounting. Additions to the qualified asset account are limited to the account limit. The account limit is the amount reasonably and actuarially necessary to fund claims uncured but unpaid (as of the close of the taxable year) and administrative costs with respect to such claims.

These limits do not apply to a welfare benefit fund that is part of a plan (referred to a "10-or-more employer" plan), to which (1) more than one employer contributes, and (2) no employer normally contributes more than 10 percent of the total contributions, provided that the plan may not maintain experience rating arrangements with respect to individual employers.

Explanation of Provision

The bill allows deductions for contributions to fund a reserve for medical benefits (other than retiree medical benefits) for future years provided through a bona fide association as defined in section 2791(d)(3) of the Public Health Service Act. In such case, the account limit may

¹⁹⁵ Code sec. 404(c).

include a reserve not to exceed 35 percent of the sum of (1) qualified direct costs, and (2) the change in claims incurred, but unpaid for such taxable year with respect to medical benefits (other than post-retirement medical benefits).

Effective Date

The provision is effective for taxable years ending after December 31, 2006.

4. Tax treatment of combined annuity or life insurance contracts with a long-term care insurance feature (secs. 72, 1035, and 7702B and new sec. 6050U of the Code)

Present Law

Annuity contracts

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

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

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

Long-term care insurance contracts

Tax treatment

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

A qualified long-term care insurance contract is treated as an accident and health insurance contract (sec. 7702B(a)(1)). Amounts received under the contract generally are excludable from income as amounts received for personal injuries or sickness (sec. 104(a)(3)). The excludable amount is subject to a dollar cap of \$250 per day or \$91,250 annually (for 2006), as indexed, on per diem contracts only (sec. 7702B(d)). If payments under such contracts exceed the dollar cap, then the excess is excludable only to the extent of costs in excess of the dollar cap that are incurred for long-term care services. Amounts in excess of the dollar cap, with respect to which no actual costs were incurred for long-term care services, are fully includable in income without regard to the rules relating to return of basis under section 72.

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

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

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

Definitions

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

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

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

Long-term care riders on life insurance contracts

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

The guideline premium limitation applicable under section 7702(c)(2) is increased by the sum of charges (but not premium payments) against the life insurance contract’s cash surrender value, the imposition of which reduces premiums paid for the contract (within the meaning of sec. 7702(f)(1)). Thus, a policyholder can pre-fund to a greater degree a life insurance policy with a long-term care rider without causing the policy to lose its tax-favored treatment as life insurance.

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

Tax-free exchanges of insurance contracts

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

Capitalization of certain policy acquisition expenses of insurance companies

In the case of an insurance company, specified policy acquisition expenses for any taxable year are required to be capitalized, and are amortized generally over the 120-month period beginning with the first month in the second half of the taxable year (sec. 848). Specified policy acquisition expenses are determined as that portion of the insurance company’s general deductions for the taxable year that does not exceed a specific percentage of the net premiums for the taxable year on each of three categories of insurance contracts. For annuity contracts, the

percentage is 1.75; for group life insurance contracts, the percentage is 2.05; and for all other specified insurance contracts, the percentage is 7.7. With certain exceptions, a specified insurance contract is any life insurance, annuity, or noncancellable accident and health insurance contract or combination thereof.

Explanation of Provision

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

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

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

The provision provides that, except as otherwise provided in regulations, for Federal tax purposes, in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract or an annuity contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract. The term “portion” means only the terms and benefits under a life insurance contract or annuity contract that are in addition to the terms and benefits under the contract without regard to long-term care coverage. As a result, if the applicable requirements are met by the long-term care portion of the contract, amounts received under the contract as provided by the rider are treated in the same manner as long-term care insurance benefits, whether or not the payment of such amounts causes a reduction in the life insurance contract’s death benefit or cash surrender value or in the annuity contract’s cash value.

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

The provision provides that, for taxable years beginning after December 31, 2009, the guideline premium limitation is not directly increased by charges against a life insurance contract’s cash surrender value for coverage under the qualified long-term care insurance portion of the contract. Rather, because such charges are not included in the holder’s income by reason

of new section 72(e)(11),¹⁹⁶ the charges reduce premiums paid under section 7702(f)(1), for purposes of the guideline premium limitation of section 7702. The amount by which premiums paid (under 7702(f)(1)) are reduced under this rule is intended to be the sum of any charges (but not premium payments) against the life insurance contract's cash surrender value (within the meaning of section 7702(f)(2)(a)) for long-term care coverage made to that date under the contract. For taxable years beginning before January 1, 2010, the present-law rule of section 7702B(e)(2) before amendment by the bill (the so-called "pay-as-you-go" rule) increases the guideline premium limitation by this same amount, reduced by charges the imposition of which reduces the premiums paid under the contract. Thus, the provision of the bill recreates the result of the "pay-as-you-go" rule (which is repealed by the provision) as a reduction in premiums paid rather than as an increase in the guideline premium limitation.

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

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

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

The provision clarifies that, effective as if included in the Health Insurance Portability and Accountability Act of 1996 (when section 7702B was enacted), except as otherwise provided in regulations, for Federal tax purposes (not just for purposes of section 7702B), in the case of a long-term care insurance contract (whether or not qualified) provided by a rider on or as part of a life insurance contract, the portion of the contract providing long-term care insurance coverage is treated as a separate contract.

¹⁹⁶ Because such charges are not included in the holder's income under new section 72(e)(11), the effect would be to increase the guideline premium limitation under present-law section 7702B(e)(2)(A) by the amount of the charges and simultaneously to reduce it by the same charges under section 7702B(e)(2)(B). Such charges that are not included in income serve to reduce premiums paid under section 7702(f)(1), and therefore would cancel each other out under 7702B(e)(2)(A) and (B).

Effective Date

The provisions are effective generally for contracts issued after December 31, 1996, but only with respect to taxable years beginning after December 31, 2009. The provisions relating to tax-free exchanges apply with respect to exchanges occurring after December 31, 2009. The provision relating to information reporting applies to charges made after December 31, 2009. The provision relating to policy acquisition expenses applies to specified policy acquisition expenses determined for taxable years beginning after December 31, 2009. The technical amendment relating to long-term care insurance coverage under section 7702B(e) is effective as if included with the underlying provisions of the Health Insurance Portability and Accountability Act of 1996.

5. Permit tax-free distributions from governmental retirement plans for premiums for health and long-term care insurance for public safety officers (sec. 402 of the Code)

Present Law

Under present law, a distribution from a qualified retirement plan under section 401(a), a qualified annuity plan under section 403(a), a tax-sheltered annuity under section 403(b) (a “403(b) annuity”), an eligible deferred compensation plan maintained by a State or local government under section 457 (a “governmental 457 plan”), or an individual retirement arrangement under section 408 (an “IRA”) generally is included in income for the year distributed (except to the extent the amount received constitutes a return of after-tax contributions or a qualified distribution from a Roth IRA).¹⁹⁷ In addition, a distribution from a qualified retirement or annuity plan, a 403(b) annuity, or an IRA received before age 59½, death, or disability generally is subject to a 10-percent early withdrawal tax on the amount includible in income, unless an exception applies.¹⁹⁸

Explanation of Provision

The bill provides that certain pension distributions from an eligible retirement plan used to pay for qualified health insurance premiums are excludible from income, up to a maximum exclusion of \$3,000 annually. An eligible retirement plan includes a governmental qualified retirement or annuity plan, 403(b) annuity, or 457 plan. The exclusion applies with respect to eligible retired public safety officers who make an election to have qualified health insurance premiums deducted from amounts distributed from an eligible retirement plan and paid directly to the insurer. An eligible retired public safety officer is an individual who, by reason of disability or attainment of normal retirement age, is separated from service as a public safety

¹⁹⁷ Secs. 402(a), 403(a), 403(b), 408(d), and 457(a).

¹⁹⁸ Sec. 72(t).

officer¹⁹⁹ with the employer who maintains the eligible retirement plan from which pension distributions are made.

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

Effective Date

The provision is effective for distributions in taxable years beginning after December 31, 2006.

¹⁹⁹ The term "public safety officer" has the same meaning as under section 1204(8)(A) of the Omnibus Crime Control and Safe Streets Act of 1986.

E. United States Tax Court Modernization

1. Judges of the Tax Court (secs. 7447, 7448, and 7472 of the Code)

Present Law

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.²⁰⁰ The salary of a Tax Court judge is the same salary as received by a U.S. District Court judge.²⁰¹ Present law also provides Tax Court judges with some benefits that correspond to benefits provided to U.S. District Court judges, including specific retirement and survivor benefit programs for Tax Court judges.²⁰²

Under the retirement program, a Tax Court judge may elect to receive retirement pay from the Tax Court in lieu of benefits under another Federal retirement program. A Tax Court judge may also elect to participate in a plan providing annuity benefits for the judge's surviving spouse and dependent children (the "survivors' annuity plan"). Generally, benefits under the survivors' annuity plan are payable only if the judge has performed at least five years of service. Cost-of-living increases in benefits under the survivors' annuity plan are generally based on increases in pay for active judges.

Tax Court judges participate in the Federal Employees Group Life Insurance program (the "FEGLI" program). Retired Tax Court judges are eligible to participate in the FEGLI program as the result of an administrative determination of their eligibility, rather than a specific statutory provision.

Tax Court judges are not covered by the leave system for Federal Executive Branch employees. As a result, an individual who works in the Federal Executive Branch before being appointed to the Tax Court does not continue to accrue annual leave under the same leave program and may not use leave accrued prior to his or her appointment to the Tax Court.

Tax Court judges are not eligible to participate in the Thrift Savings Plan.

Under the retirement program for Tax Court judges, retired judges generally receive retired pay equal to the rate of salary of an active judge and must be available for recall to perform judicial duties as needed by the court for up to 90 days a year (unless the judge consents to more). However, retired judges may elect to freeze the amount of their retired pay, and those who do so are not available for recall.

Retired Tax Court judges on recall are subject to the limitations on outside earned income that apply to active Federal employees under the Ethics in Government Act of 1978. However, retired District Court judges on recall may receive compensation for teaching without regard to

²⁰⁰ Sec. 7441.

²⁰¹ Sec. 7443(c).

²⁰² Secs. 7447 and 7448.

the limitations on outside earned income. Retired Tax Court judges who elect to freeze the amount of their retired pay (thus making themselves unavailable for recall) are not subject to the limitations on outside earned income.

Explanation of Provision

Cost-of-living adjustments for survivor annuities

The bill provides that cost-of-living increases in benefits under the survivors' annuity plan are generally based on cost-of-living increases in benefits paid under the Civil Service Retirement System.

Life insurance coverage

In the case of a Tax Court judge age 65 or over, the Tax Court is authorized to pay on behalf of the judge any increase in employee premiums under the FEGLI program that occur after the date of enactment, including expenses generated by such payment, as authorized by the chief judge of the Tax Court in a manner consistent with payments authorized by the Judicial Conference of the United States (i.e., the body with policy-making authority over the administration of the courts of the Federal judicial branch).

Thrift Savings Plan participation

Under the provision, Tax Court judges are permitted to participate in the Thrift Savings Plan. A Tax Court judge is not eligible for agency contributions to the Thrift Savings Plan.

Effective Date

The provisions are effective on the date of enactment, except that the provision relating to cost-of-living increases in benefits under the survivors' annuity plan applies with respect to increases in Civil Service Retirement benefits taking effect after the date of enactment.

2. Special trial judges of the Tax Court (sec. 7448 and new sec. 7443C of the Code)

Present Law

The Tax Court is established by the Congress pursuant to Article I of the U.S. Constitution.²⁰³ The chief judge of the Tax Court may appoint special trial judges to handle certain cases.²⁰⁴ Special trial judges serve for an indefinite term. Special trial judges receive a salary of 90 percent of the salary of a Tax Court judge and are generally covered by the benefit programs that apply to Federal executive branch employees, including the Civil Service Retirement System or the Federal Employees' Retirement System.

²⁰³ Sec. 7441.

²⁰⁴ Sec. 7443A.

Explanation of Provision

Survivors' annuity plan

Under the provision, magistrate judges of the Tax Court may elect to participate in the survivors' annuity plan for Tax Court judges. An election to participate in the survivors' annuity plan must be filed not later than the latest of: (1) twelve months after the date of enactment of the provision; (2) six months after the date the judge takes office; or (3) six months after the date the judge marries.

Recall of retired special trial judges

The provision provides rules under which a retired special trial judge may be recalled to perform services for up to 90 days a year.

Effective Date

The provisions are effective on the date of enactment.

3. Consolidate review of collection due process cases in the Tax Court (sec. 6330(d) of the Code)

Present Law

In general, the IRS is required to notify taxpayers that they have a right to a fair and impartial hearing before levy may be made on any property or right to property.²⁰⁵ Similar rules apply with respect to liens.²⁰⁶ The hearing is held by an impartial officer from the IRS Office of Appeals, who is required to issue a determination with respect to the issues raised by the taxpayer at the hearing. The taxpayer is entitled to appeal that determination to a court. The appeal must be brought to the Tax Court, unless the Tax Court does not have jurisdiction over the underlying tax liability. If that is the case, then the appeal must be brought in the district court of the United States.²⁰⁷ If a court determines that an appeal was not made to the correct court, the taxpayer has 30 days after such determination to file with the correct court.

The Tax Court is established under Article I of the United States Constitution²⁰⁸ and is a court of limited jurisdiction.²⁰⁹ The Tax Court only has the jurisdiction that is expressly

²⁰⁵ Sec. 6330(a).

²⁰⁶ Sec. 6320.

²⁰⁷ Sec. 6330(d).

²⁰⁸ Sec. 7441.

²⁰⁹ Sec. 7442.

conferred on it by statute.²¹⁰ For example, the jurisdiction of the Tax Court includes the authority to hear disputes concerning notices of income tax deficiency, certain types of declaratory judgment, and worker classification status, among others, but does not include jurisdiction over most excise taxes imposed by the Internal Revenue Code. Thus, the Tax Court may not have jurisdiction over the underlying tax liability with respect to an appeal of a due process hearing relating to a collections matter. As a practical matter, many cases involving appeals of a due process hearing (whether within the jurisdiction of the Tax Court or a district court) do not involve the underlying tax liability.

Explanation of Provision

The provision modifies the jurisdiction of the Tax Court by providing that all appeals of collection due process determinations are to be made to the United States Tax Court.

Effective Date

The provision applies to determinations made after the date which is 60 days after the date of enactment.

4. Extend authority for special trial judges to hear and decide certain employment status cases (sec. 7443A of the Code)

Present Law

In connection with the audit of any person, if there is an actual controversy involving a determination by the IRS as part of an examination that (1) one or more individuals performing services for that person are employees of that person or (2) that person is not entitled to relief under section 530 of the Revenue Act of 1978, the Tax Court has jurisdiction to determine whether the IRS is correct and the proper amount of employment tax under such determination.²¹¹ Any redetermination by the Tax Court has the force and effect of a decision of the Tax Court and is reviewable.

An election may be made by the taxpayer for small case procedures if the amount of the employment taxes in dispute is \$50,000 or less for each calendar quarter involved.²¹² The decision entered under the small case procedure is not reviewable in any other court and should not be cited as authority.

The chief judge of the Tax Court may assign proceedings to special trial judges. The Code enumerates certain types of proceedings that may be so assigned and may be decided by a

²¹⁰ Sec. 7442.

²¹¹ Sec. 7436.

²¹² Sec. 7436(c).

special trial judge. In addition, the chief judge may designate any other proceeding to be heard by a special trial judge.²¹³

Explanation of Provision

The provision clarifies that the chief judge of the Tax Court may assign to special trial judges any employment tax cases that are subject to the small case procedure and may authorize special trial judges to decide such small tax cases.

Effective Date

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment.

5. Confirmation of Tax Court authority to apply equitable recoupment (sec. 6214(b) of the Code)

Present Law

Equitable recoupment is a common-law equitable principle that permits the defensive use of an otherwise time-barred claim to reduce or defeat an opponent's claim if both claims arise from the same transaction. U.S. District Courts and the U.S. Court of Federal Claims, the two Federal tax refund forums, may apply equitable recoupment in deciding tax refund cases.²¹⁴ In *Estate of Mueller v. Commissioner*,²¹⁵ the Court of Appeals for the Sixth Circuit held that the United States Tax Court (the "Tax Court") may not apply the doctrine of equitable recoupment. More recently, the Court of Appeals for the Ninth Circuit, in *Branson v. Commissioner*,²¹⁶ held that the Tax Court may apply the doctrine of equitable recoupment.

Explanation of Provision

The provision confirms that the Tax Court may apply the principle of equitable recoupment to the same extent that it may be applied in Federal civil tax cases by the U.S. District Courts or the U.S. Court of Claims. No implication is intended as to whether the Tax Court has the authority to continue to apply other equitable principles in deciding matters over which it has jurisdiction.

²¹³ Sec. 7443A.

²¹⁴ See *Stone v. White*, 301 U.S. 532 (1937); *Bull v. United States*, 295 U.S. 247 (1935).

²¹⁵ 153 F.3d 302 (6th Cir.), *cert. den.*, 525 U.S. 1140 (1999).

²¹⁶ 264 F.3d 904 (9th Cir.), *cert. den.*, 2002 U.S. LEXIS 1545 (U.S. Mar. 18, 2002).

Effective Date

The provision is effective for any action or proceeding in the Tax Court with respect to which a decision has not become final as of the date of enactment.

6. Tax Court filing fee (sec. 7451 of the Code)

Present Law

The Tax Court is authorized to impose a fee of up to \$60 for the filing of any petition for the redetermination of a deficiency or for declaratory judgments relating to the status and classification of 501(c)(3) organizations, the judicial review of final partnership administrative adjustments, and the judicial review of partnership items if an administrative adjustment request is not allowed in full.²¹⁷ The statute does not specifically authorize the Tax Court to impose a filing fee for the filing of a petition for review of the IRS's failure to abate interest or for failure to award administrative costs and other areas of jurisdiction for which a petition may be filed. The practice of the Tax Court is to impose a \$60 filing fee in all cases commenced by petition.²¹⁸

Explanation of Provision

The provision provides that the Tax Court is authorized to charge a filing fee of up to \$60 in all cases commenced by the filing of a petition. No negative inference is to be drawn as to whether the Tax Court has the authority under present law to impose a filing fee for any case commenced by the filing of a petition.

Effective Date

The provision is effective on the date of enactment.

7. Use of practitioner fee (sec. 7475(b) of the Code)

Present Law

The Tax Court is authorized to impose a fee of up to \$30 per year on practitioners admitted to practice before the Tax Court.²¹⁹ These fees are to be used to employ independent counsel to pursue disciplinary matters.

Explanation of Provision

The provision provides that Tax Court fees imposed on practitioners also are available to provide services to pro se taxpayers (i.e., a taxpayer representing himself) that will assist such

²¹⁷ Sec. 7451.

²¹⁸ See Rule 20(b) of the Tax Court Rules of Practice and Procedure.

²¹⁹ Sec. 7475.

taxpayers in controversies before the Court. For example, fees could be used for programs to educate pro se taxpayers on the procedural requirements for contesting a tax deficiency before the Tax Court.

Effective Date

The provision is effective on the date of enactment.

F. Other Provisions

1. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules (sec. 1505 of the Taxpayer Relief Act of 1997, and secs. 401(a) and 401(k) of the Code)

Present Law

A qualified retirement plan maintained by a State or local government is exempt from the nondiscrimination and minimum participation requirements. A cash or deferred arrangement maintained by a State or local government is also treated as meeting the participation and nondiscrimination requirements applicable to such a qualified cash or deferred arrangement. Other governmental plans are subject to these requirements.²²⁰

Explanation of Provision

The provision exempts all governmental plans from the nondiscrimination and minimum participation rules. The provision also treats all governmental cash or deferred arrangements as meeting the participation and nondiscrimination requirements applicable to a qualified cash or deferred arrangement.

Effective Date

The provision is effective for any year beginning after the date of enactment.

2. Eliminate aggregate limit for usage of excess funds from black lung disability trusts to pay for retiree health (secs. 501(c)(21) and 9705 of the Code)

Present Law

Qualified black lung benefit trusts

A qualified black lung benefit trust is exempt from Federal income taxation. Contributions to a qualified black lung benefit trust generally are deductible to the extent such contributions are necessary to fund the trust.

Under present law, no assets of a qualified black lung benefit trust may be used for, or diverted to, any purpose other than (1) to satisfy liabilities, or pay insurance premiums to cover liabilities, arising under the Black Lung Acts, (2) to pay administrative costs of operating the trust, (3) to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents (within certain limits) or (4) investment in Federal, State, or local securities and obligations, or in time demand deposits in a bank or

²²⁰ The IRS has announced that governmental plans that are subject to the nondiscrimination requirements are deemed to satisfy such requirements pending the issuance of final regulations addressing this issue. Notice 2003-6, 2003-3 I.R.B. 298; Notice 2001-46, 2001-2 C.B. 122.

insured credit union. Additionally, trust assets may be paid into the national Black Lung Disability Trust Fund, or into the general fund of the U.S. Treasury.

The amount of assets in qualified black lung benefit trusts available to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents may not exceed a yearly limit or an aggregate limit, whichever is less. The yearly limit is the amount of trust assets in excess of 110 percent of the present value of the liability for black lung benefits determined as of the close of the preceding taxable year of the trust. The aggregate limit is the excess of the sum of the yearly limit as of the close of the last taxable year ending before October 24, 1992, plus earnings thereon as of the close of the taxable year preceding the taxable year involved over the aggregate payments for accident of health benefits for retired coal miners and their spouses and dependents made from the trust since October 24, 1992. Each of these determinations is required to be made by an independent actuary.

In general, amounts used to pay retiree accident or health benefits are not includible in the income of the company, nor is a deduction allowed for such amounts.

United Mine Workers of America Combined Benefit Fund

The United Mine Workers of America (“UMWA”) Combined Benefit Fund was established by the Coal Industry Retiree Health Benefit Act of 1992 to assume responsibility of payments for medical care expenses of retired miners and their dependents who were eligible for health care from the private 1950 and 1974 UMWA Benefit Plans. The UMWA Combined Benefit Fund is financed by assessments on current and former signatories to labor agreements with the UMWA, past transfers from an overfunded United Mine Workers pension fund, and transfers from the Abandoned Mine Reclamation Fund.

Explanation of Provision

The provision eliminates the aggregate limit on the amount of excess black lung benefit trust assets that may be used to pay accident and health benefits or premiums for insurance exclusively covering such benefits (including administrative and other incidental expenses relating to such benefits) for retired coal miners and their spouses and dependents.

Effective Date

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

3. Tax treatment of company-owned life insurance (“COLI”) (new secs. 101(j) and 6039I of the Code)

Present Law

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.²²¹ No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).²²²

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer’s investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.²²³

Premium and interest deduction limitations²²⁴

Premiums

Under present law, no deduction is permitted for premiums paid on any life insurance, annuity or endowment contract, if the taxpayer is directly or indirectly a beneficiary under the contract.²²⁵

²²¹ Sec. 101(a).

²²² This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract (sec. 7702).

²²³ Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59½ and in certain other circumstances (secs. 72(e) and (v)). A modified endowment contract is a life insurance contract that does not meet a statutory “7-pay” test, i.e., generally is funded more rapidly than seven annual level premiums (sec. 7702A).

²²⁴ In addition to the statutory limitations described below, interest deductions under company-owned life insurance arrangements have also been limited by recent cases applying general principles of tax law. See *Winn-Dixie Stores, Inc. v. Commissioner*, 113 T.C. 254 (1999), aff’d 254 F.3d 1313 (11th Cir. 2001), cert. denied, April 15, 2002; *Internal Revenue Service v. CM Holdings, Inc.*, 254 B.R. 578 (D. Del. 2000), aff’d, 301 F.3d 96 (3d Cir. 2002); *American Electric Power, Inc. v. U.S.*, 136 F. Supp. 2d 762 (S. D. Ohio 2001), aff’d, 326 F.3d 737 (6th Cir. 2003), reh. denied, 338 F.3d 534 (6th Cir. 2003), cert. denied, U.S. No. 03-529 (Jan. 12, 2004); *Dow Chemical Company v. U.S.*, 435 F.3d 594 (6th Cir. 2006), rev’g 250 F. Supp. 2d 748 (E.D. Mich. 2003) as modified, 278 F. Supp. 2d 844 (E.D. Mich. 2003).

²²⁵ Sec. 264(a)(1).

Interest paid or accrued with respect to the contract

No deduction generally is allowed for interest paid or accrued on any debt with respect to a life insurance, annuity or endowment contract covering the life of any individual.²²⁶ An exception is provided under this provision for insurance of key persons.

Interest that is otherwise deductible (e.g., is not disallowed under other applicable rules or general principles of tax law) may be deductible under the key person exception, to the extent that the aggregate amount of the debt does not exceed \$50,000 per insured individual. The deductible interest may not exceed the amount determined by applying a rate based on a Moody's Corporate Bond Yield Average-Monthly Average Corporates. A key person is an individual who is either an officer or a 20-percent owner of the taxpayer. The number of individuals that can be treated as key persons may not exceed the greater of (1) five individuals, or (2) the lesser of five percent of the total number of officers and employees of the taxpayer, or 20 individuals.²²⁷

Pro rata interest limitation

A pro rata interest deduction disallowance rule also applies. Under this rule, in the case of a taxpayer other than a natural person, no deduction is allowed for the portion of the taxpayer's interest expense that is allocable to unborrowed policy cash surrender values.²²⁸ Interest expense is allocable to unborrowed policy cash values based on the ratio of (1) the taxpayer's average unborrowed policy cash values of life insurance, annuity and endowment contracts, to (2) the sum of the average unborrowed cash values (or average adjusted bases, for other assets) of all the taxpayer's assets.

Under the pro rata interest disallowance rule, an exception is provided for any contract owned by an entity engaged in a trade or business, if the contract covers an individual who is a 20-percent owner of the entity, or an officer, director, or employee of the trade or business. The exception also applies to a joint-life contract covering a 20-percent owner and his or her spouse.

"Single premium" and "4-out-of-7" limitations

Other interest deduction limitation rules also apply with respect to life insurance, annuity and endowment contracts. Present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a single premium life insurance, annuity or endowment contract.²²⁹ In addition, present law provides that no deduction is allowed for any amount paid or accrued on debt incurred or continued to purchase or carry a

²²⁶ Sec. 264(a)(4).

²²⁷ Sec. 264(e)(3).

²²⁸ Sec. 264(f). This applies to any life insurance, annuity or endowment contract issued after June 8, 1997.

²²⁹ Sec. 264(a)(2).

life insurance, annuity or endowment contract pursuant to a plan of purchase that contemplates the systematic direct or indirect borrowing of part or all of the increases in the cash value of the contract (either from the insurer or otherwise).²³⁰ Under this rule, several exceptions are provided, including an exception if no part of four of the annual premiums due during the initial seven-year period is paid by means of such debt (known as the “4-out-of-7 rule”).

Definitions of highly compensated employee

Present law defines highly compensated employees and individuals for various purposes. For purposes of nondiscrimination rules relating to qualified retirement plans, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if the employee (1) was a five-percent owner of the employer at any time during the year or the preceding year or (2) either (a) had compensation for the preceding year in excess of \$95,000 (for 2005) or (b) at the election of the employer had compensation in excess of \$95,000 (for 2005) and was in the highest paid 20 percent of employees for such year.²³¹ The \$95,000 dollar amount is indexed for inflation.

For purposes of nondiscrimination rules relating to self-insured medical reimbursement plans, a highly compensated individual is an employee who is one of the five highest paid officers of the employer, a shareholder who owns more than 10 percent of the value of the stock of the employer, or is among the highest paid 25 percent of all employees.²³²

Explanation of Provision

The provision provides generally that, in the case of an employer-owned life insurance contract, the amount excluded from the applicable policyholder’s income as a death benefit cannot exceed the premiums and other amounts paid by such applicable policyholder for the contract. The excess death benefit is included in income.

Exceptions to this income inclusion rule are provided. In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured individual who, with respect to the applicable policyholder, was an employee at any time during the 12-month period before the insured’s death, or who, at the time the contract was issued, was a director or highly compensated employee or highly compensated individual. For this purpose, such a person is one who is either: (1) a highly compensated employee as defined under the rules relating to qualified retirement plans, determined without regard to the election regarding the top-paid 20 percent of employees; or (2) a highly compensated individual as

²³⁰ Sec. 264(a)(3).

²³¹ Sec. 414(q). For purposes of determining the top-paid 20 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

²³² Sec. 105(h)(5). For purposes of determining the top-paid 25 percent of employees, certain employees, such as employees subject to a collective bargaining agreement, are disregarded.

defined under the rules relating to self-insured medical reimbursement plans, determined by substituting the highest-paid 35 percent of employees for the highest-paid 25 percent of employees.²³³

In the case of an employer-owned life insurance contract with respect to which the notice and consent requirements of the provision are met, the income inclusion rule does not apply to an amount received by reason of the death of an insured, to the extent the amount is (1) paid to a member of the family²³⁴ of the insured, to an individual who is the designated beneficiary of the insured under the contract (other than an applicable policyholder), to a trust established for the benefit of any such member of the family or designated beneficiary, or to the estate of the insured; or (2) used to purchase an equity (or partnership capital or profits) interest in the applicable policyholder from such a family member, beneficiary, trust or estate. It is intended that such amounts be so paid or used by the due date of the tax return for the taxable year of the applicable policyholder in which they are received as a death benefit under the insurance contract, so that the payment of the amount to such a person or persons, or the use of the amount to make such a purchase, is known in the taxable year for which the exception from the income inclusion rule is claimed.

An employer-owned life insurance contract is defined for purposes of the provision as a life insurance contract which (1) is owned by a person engaged in a trade or business and under which such person (or a related person) is directly or indirectly a beneficiary, and (2) covers the life of an individual who is an employee with respect to the trade or business of the applicable policyholder on the date the contract is issued.

An applicable policyholder means, with respect to an employer-owned life insurance contract, the person (including related persons) that owns the contract, if the person is engaged in a trade or business, and if the person (or a related person) is directly or indirectly a beneficiary under the contract.

For purposes of the provision, a related person includes any person that bears a relationship specified in section 267(b) or 707(b)(1)²³⁵ or is engaged in trades or businesses that are under common control (within the meaning of section 52(a) or (b)).

²³³ As under present law, certain employees are disregarded in making the determinations regarding the top-paid groups.

²³⁴ For this purpose, a member of the family is defined in section 267(c)(4) to include only the individual's brothers and sisters (whether by the whole or half blood), spouse, ancestors, and lineal descendants.

²³⁵ The relationships include specified relationships among family members, shareholders and corporations, corporations that are members of a controlled group, trust grantors and fiduciaries, tax-exempt organizations and persons that control such organizations, commonly controlled S corporations, partnerships and C corporations, estates and beneficiaries, commonly controlled partnerships, and partners and partnerships. Detailed rules apply to determine the specific relationships.

The notice and consent requirements of the provision are met if, before the issuance of the contract, (1) the employee is notified in writing that the applicable policyholder intends to insure the employee's life, and is notified of the maximum face amount at issue of the life insurance contract that the employer might take out on the life of the employee, (2) the employee provides written consent to being insured under the contract and that such coverage may continue after the insured terminates employment, and (3) the employee is informed in writing that an applicable policyholder will be a beneficiary of any proceeds payable on the death of the employee.

For purposes of the provision, an employee includes an officer, a director, and a highly compensated employee; an insured means, with respect to an employer-owned life insurance contract, an individual covered by the contract who is a U.S. citizen or resident. In the case of a contract covering the joint lives of two individuals, references to an insured include both of the individuals.

The provision requires annual reporting and recordkeeping by applicable policyholders that own one or more employer-owned life insurance contracts. The information to be reported is (1) the number of employees of the applicable policyholder at the end of the year, (2) the number of employees insured under employer-owned life insurance contracts at the end of the year, (3) the total amount of insurance in force at the end of the year under such contracts, (4) the name, address, and taxpayer identification number of the applicable policyholder and the type of business in which it is engaged, and (5) a statement that the applicable policyholder has a valid consent (in accordance with the consent requirements under the provision) for each insured employee and, if all such consents were not obtained, the total number of insured employees for whom such consent was not obtained. The applicable policyholder is required to keep records necessary to determine whether the requirements of the reporting rule and the income inclusion rule of new section 101(j) are met.

Effective Date

The provision generally applies to contracts issued after the date of enactment, except for contracts issued after such date pursuant to an exchange described in section 1035 of the Code. In addition, certain material increases in the death benefit or other material changes will generally cause a contract to be treated as a new contract, with an exception for existing lives under a master contract. Increases in the death benefit that occur as a result of the operation of section 7702 of the Code or the terms of the existing contract, provided that the insurer's consent to the increase is not required, will not cause a contract to be treated as a new contract. In addition, certain changes to a contract will not be considered material changes so as to cause a contract to be treated as a new contract. These changes include administrative changes, changes from general to separate account, or changes as a result of the exercise of an option or right granted under the contract as originally issued.

Examples of situations in which death benefit increases would not cause a contract to be treated as a new contract include the following:

1. Section 7702 provides that life insurance contracts need to either meet the cash value accumulation test of section 7702(b) or the guideline premium requirements of section

7702(c) and the cash value corridor of section 7702(d). Under the corridor test, the amount of the death benefit may not be less than the applicable percentage of the cash surrender value. Contracts may be written to comply with the corridor requirement by providing for automatic increases in the death benefit based on the cash surrender value. Death benefit increases required by the corridor test or the cash value accumulation test do not require the insurer's consent at the time of increase and occur in order to keep the contract in compliance with section 7702.

2. Death benefits may also increase due to normal operation of the contract. For example, for some contracts, policyholder dividends paid under the contract may be applied to purchase paid-up additions, which increase the death benefits. The insurer's consent is not required for these death benefit increases.
3. For variable contracts and universal life contracts, the death benefit may increase as a result of market performance or the contract design. For example, some contracts provide that the death benefit will equal the cash value plus a specified amount at risk. With these contracts, the amount of the death benefit at any time will vary depending on changes in the cash value of the contract. The insurance company's consent is not required for these death benefit increases.

4. Treatment of test room supervisors and proctors who assist in the administration of college entrance and placement exams (sec. 530 of the Revenue Reconciliation Act of 1978)

Present Law

Section 530 of the Revenue Act of 1978 prohibits the Internal Revenue Service from challenging a taxpayer's treatment of an individual as an independent contractor for employment tax purposes if the taxpayer (1) has a reasonable basis for such treatment and (2) consistently treats the individual, and any other individual holding a substantially similar position, as an independent contractor.

Explanation of Provision

Under the bill, section 530 of the Revenue Act of 1978 is amended to provide that in the case of an individual providing services as a test proctor or room supervisor by assisting in the administration of college entrance or placements examinations, the consistency requirement does not apply with respect to services performed after December 31, 2006 (and remuneration paid with respect to such services). The provision applies if the individual (1) is performing the services for a tax-exempt organization, and (2) is not otherwise treated as an employee of such organization for purposes of employment taxes. Thus, under the bill, if the requirements are satisfied, the IRS is prohibited from challenging the treatment of such individuals as independent contractors for employment tax purposes, even if the organization previously treated such individuals as employees.

Effective Date

The provision is effective for remuneration paid for services performed after December 31, 2006.

5. Rule for church plans which self-annuitize (sec. 401(a)(9) of the Code)

Present Law

Minimum distribution rules apply to qualified retirement plans (sec. 401(a)(9)). Special rules apply in the case of payments under an annuity contract purchased with the employee's benefit by the plan from an insurance company.²³⁶ If certain requirements are satisfied, these special rules apply to annuity payments from a retirement income account maintained by a church (or certain other organizations as described in sec. 403(b)(9)) even though the payments are not made under an annuity purchased from an insurance company.²³⁷

Explanation of Provision

The bill provides that annuity payments provided with respect to any account maintained for a participant or beneficiary under a qualified church plan does not fail to meet the minimum distribution rules merely because the payments are not made under an annuity contract purchased from an insurance company if such payments would not fail such requirements if provided with respect to a retirement income account described in section 403(b)(9).

For purposes of the provision, a qualified church plan means any money purchase plan described in section 401(a) which (1) is a church plan (as defined in section 414(e)) with respect to which the election provided by section 410(d) has not been made, and (2) was in existence on April 17, 2002.

Effective Date

The provision is effective for years beginning after the date of enactment. No inference is intended from the provision with respect to the proper application of the minimum distribution rules to church plans before the effective date.

6. Exemption for income from leveraged real estate held by church plans (sec. 514(c)(9) of the Code)

Present Law

Debt-financed income of a tax-exempt entity is subject to unrelated business income tax ("UBIT") under section 514 of the Code. Debt-financed property generally is property that is held to produce income and with respect to which there is acquisition indebtedness.

There is an exception to the UBIT rules for debt-financed property held by qualifying organizations (sec. 514(c)(9)). Qualified organizations include retirement plans qualified under section 401(a).

²³⁶ Treas. Reg. sec. 1.401(a)(9)-6, A-4.

²³⁷ Treas. Reg. sec. 1.403(b)-3, A-1(c)(3).

Explanation of Provision

The bill provides that a retirement income account of a church (or certain other organizations) as defined in section 403(b)(9) is a qualified organization for purposes of the exemption from the UBIT debt-financed property rules.

Effective Date

The provision is effective for taxable years beginning on or after the date of enactment.

7. Church plan rule for benefit limitations (sec. 415 of the Code)

Present Law

Section 415 limits the amount of benefits and contributions that may be provided under a tax-qualified plan. In the case of a defined benefit plan, the limit on annual benefits payable under the plan is the lesser of: (1) a dollar amount which is adjusted for inflation (\$175,000 for 2006); and (2) 100 percent of the participant's compensation for the highest three years. Special rules apply in some cases.

Explanation of Provision

The provision provides that the 100 percent of compensation limit does not apply to a plan maintained by a church or qualified church controlled organization defined in section 3121(w)(3)(A) except with respect to "highly compensated benefits". The term "highly compensated benefits" means any benefits accrued for an employee in any year on or after the first year in which such employee is a highly compensated employee (as defined in sec. 414(q)) of the organization. For purposes of applying the 100 percent of compensation limit to highly compensated benefits, all the benefits of the employee which would otherwise be taken into account in applying the limit shall be taken into account, i.e., the limit does not apply only to those benefits accrued on or after the first year in which the employee is a highly compensated employee.

Effective Date

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

8. Gratuitous transfers for the benefit of employees (sec. 664 of the Code)

Present Law

Present law permits certain limited transfers of qualified employer securities by charitable remainder trusts to an employee stock ownership plan ("ESOP") without adversely affecting the status of the charitable remainder trusts under section 664. In addition, the ESOP does not fail to be a qualified plan because it complies with the requirements with respect to a qualified gratuitous transfer.

A number of requirements must be satisfied for a transfer of securities to be a qualified gratuitous transfer, including the following: (1) the securities transferred to the ESOP must previously have passed from the decedent to a charitable remainder trust; (2) at the time of the transfer to the ESOP, family members own no more than a certain percentage of the outstanding stock of the company; (3) immediately after the transfer the ESOP owns at least 60 percent of the value of the outstanding stock of company; and (4) the ESOP meets certain requirements.

Among other requirements applicable to the ESOP, securities transferred to the ESOP are required to be allocated each year up to the applicable limit (after first allocating all other annual additions for the limitation year). The applicable limit is the lesser of (1) \$30,000 (as indexed) or (2) 25 percent of the participant's compensation.

Explanation of Provision

The provision clarifies that, under section 664, the amount of transferred securities required to be allocated each year is determined on the basis of fair market value of the securities when allocated to participants.

Effective Date

The provision is effective on the date of enactment.

TITLE IX: INCREASE IN PENSION PLAN DIVERSIFICATION AND PARTICIPATION

A. Defined Contribution Plans Required to Provide Employees with Freedom to Invest Their Plan Assets (new sec. 401(a)(35) of the Code and new sec. 204(j) of ERISA)

Present Law

In general

Defined contribution plans may permit both employees and employers to make contributions to the plan. Under a qualified cash or deferred arrangement (commonly referred to as a “section 401(k) plan”), employees may elect to make pretax contributions to a plan, referred to as elective deferrals. Employees may also be permitted to make after-tax contributions to a plan. In addition, a plan may provide for employer nonelective contributions or matching contributions. Nonelective contributions are employer contributions that are made without regard to whether the employee makes elective deferrals or after-tax contributions. Matching contributions are employer contributions that are made only if the employee makes elective deferrals or after-tax contributions.

Under the Code, elective deferrals, after-tax employee contributions, and employer matching contributions are subject to special nondiscrimination tests. Certain employer nonelective contributions may be used to satisfy these special nondiscrimination tests. In addition, plans may satisfy the special nondiscrimination tests by meeting certain safe harbor contribution requirements.

The Code requires employee stock ownership plans (“ESOPs”) to offer certain plan participants the right to diversify investments in employer securities. The Employee Retirement Income Security Act of 1974 (“ERISA”) limits the amount of employer securities and employer real property that can be acquired or held by certain employer-sponsored retirement plans. The extent to which the ERISA limits apply depends on the type of plan and the type of contribution involved.

Diversification requirements applicable to ESOPs under the Code

An ESOP is a defined contribution plan that is designated as an ESOP and is designed to invest primarily in qualifying employer securities and that meets certain other requirements under the Code. For purposes of ESOP investments, a “qualifying employer security” is defined as: (1) publicly traded common stock of the employer or a member of the same controlled group; (2) if there is no such publicly traded common stock, common stock of the employer (or member of the same controlled group) that has both voting power and dividend rights at least as great as any other class of common stock; or (3) noncallable preferred stock that is convertible into common stock described in (1) or (2) and that meets certain requirements. In some cases, an employer may design a class of preferred stock that meets these requirements and that is held only by the ESOP.

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. For example, an ESOP may include a qualified cash or deferred arrangement that permits employees to make elective deferrals.²³⁸

Under the Code, ESOPs are subject to a requirement that a participant who has attained age 55 and who has at least 10 years of participation in the plan must be permitted to diversify the investment of the participant's account in assets other than employer securities.²³⁹ The diversification requirement applies to a participant for six years, starting with the year in which the individual first meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if: (1) the plan distributes the applicable amount to the participant within 90 days after the election period; (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election; or (3) the applicable amount is transferred within 90 days of the election period to another qualified defined contribution plan of the employer providing investment options in accordance with (2).²⁴⁰

ERISA limits on investments in employer securities and real property

ERISA imposes restrictions on the investment of retirement plan assets in employer securities or employer real property.²⁴¹ A retirement plan may hold only a "qualifying" employer security and only "qualifying" employer real property.

Under ERISA, any stock issued by the employer or an affiliate of the employer is a qualifying employer security.²⁴² Qualifying employer securities also include certain publicly traded partnership interests and certain marketable obligations (i.e., a bond, debenture, note, certificate or other evidence of indebtedness). Qualifying employer real property means parcels of employer real property: (1) if a substantial number of the parcels are dispersed geographically;

²³⁸ Such an ESOP design is sometimes referred to as a "KSOP."

²³⁹ Sec. 401(a)(28). The present-law diversification requirements do not apply to employer securities held by an ESOP that were acquired before January 1, 1987.

²⁴⁰ IRS Notice 88-56, 1988-1 C.B. 540, Q&A-16.

²⁴¹ ERISA sec. 407.

²⁴² Certain additional requirements apply to employer stock held by a defined benefit pension plan or a money purchase pension plan (other than certain plans in existence before the enactment of ERISA).

(2) if each parcel of real property and the improvements thereon are suitable (or adaptable without excessive cost) for more than one use; (3) even if all of the real property is leased to one lessee (which may be an employer, or an affiliate of an employer); and (4) if the acquisition and retention of such property generally comply with the fiduciary rules of ERISA (with certain specified exceptions).

ERISA also prohibits defined benefit pension plans and money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities or employer real property if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer securities and real property. Except as discussed below with respect to elective deferrals, this 10-percent limitation generally does not apply to defined contribution plans other than money purchase pension plans.²⁴³ 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 or employer real property in a defined contribution plan.²⁴⁴

The 10-percent limitation on the acquisition of employer securities and real property 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 or real property 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 and real property does not exceed more than one percent of any employee's compensation; (2) the fair market value of all defined contribution plans maintained by the employer is no more than 10 percent of the fair market value of all retirement plans of the employer; or (3) the plan is an ESOP.

Explanation of Provision

In general

Under the provision, in order to satisfy the plan qualification requirements of the Code and the vesting requirements of ERISA, certain defined contribution plans are required to provide diversification rights with respect to amounts invested in employer securities. Such a plan is 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 includes: (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.

²⁴³ The 10-percent limitation also applies to a defined contribution plan that is part of an arrangement under which benefits payable to a participant under a defined benefit pension plan are reduced by benefits under the defined contribution plan (i.e., a "floor-offset" arrangement).

²⁴⁴ Under ERISA, a defined contribution plan is generally referred to as an individual account plan. Plans that are not subject to the 10-percent limitation on the acquisition of employer securities and employer real property are referred to as "eligible individual account plans."

The time when the diversification requirements apply depends on the type of contributions invested in employer securities.

Plans subject to requirements

The diversification requirements generally apply to an “applicable defined contribution plan,”²⁴⁵ which means a defined contribution plan holding publicly-traded employer securities (i.e., securities issued by the employer or a member of the employer’s controlled group of corporations²⁴⁶ that are readily tradable on an established securities market).

For this purpose, a plan holding employer securities that are not publicly traded is generally treated as holding publicly-traded employer securities if the employer (or any member of the employer’s controlled group of corporations) has issued a class of stock that is a publicly-traded employer security. This treatment does not apply if neither the employer nor any parent corporation²⁴⁷ of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or the issuer with respect to any member of the employer’s controlled group that has issued any publicly-traded employer security. For example, a controlled group that generally consists of corporations that have not issued publicly-traded securities may include a member that has issued publicly-traded stock (the “publicly-traded member”). In the case of a plan maintained by an employer that is another member of the controlled group, the diversification requirements do not apply to the plan, provided that neither the employer nor a parent corporation of the employer has issued any publicly-traded security or any special class of stock that grants particular rights to, or bears particular risks for, the holder or issuer with respect to the member that has issued publicly-traded stock. The Secretary of the Treasury has the authority to provide other exceptions in regulations. For example, an exception may be appropriate if no stock of the employer maintaining the plan (including stock held in the plan) is publicly traded, but a member of the employer’s controlled group has issued a small amount of publicly-traded stock.

The diversification requirements do 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 a separate plan from 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

²⁴⁵ Under ERISA, the diversification requirements apply to an “applicable individual account plan.”

²⁴⁶ For this purpose, “controlled group of corporations” has the same meaning as under section 1563(a), except that, in applying that section, 50 percent is substituted for 80 percent.

²⁴⁷ For this purpose, “parent corporation” has the same meaning as under section 424(e), i.e., 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.

the safe harbor methods of satisfying the tests) is subject to the diversification requirements under the Provision. The diversification rights applicable under the provision are broader than those applicable under the Code's present-law ESOP diversification rules. Thus, an ESOP that is subject to the new requirements is excepted from the present-law rules.²⁴⁸

The new diversification requirements also do not apply to a one-participant retirement plan. For purposes of the Code, a one-participant retirement plan is a plan that: (1) on the first day of the plan year, either covered only one individual (or the individual and his or her spouse) and the individual owned 100 percent of the plan sponsor (i.e., the employer maintaining the plan), whether or not incorporated, or covered only one or more partners (or partners and their spouses) in the plan sponsor; (2) meets the minimum coverage requirements without being combined with any other plan of the business that covers employees of the business; (3) does not provide benefits to anyone except the individuals and partners (and spouses) described in (1); (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 uses the services of leased employees.²⁴⁹ It is intended that, for this purpose, a "partner" includes an owner of a business that is treated as a partnership for tax purposes. In addition, it includes a two-percent shareholder of an S corporation.²⁵⁰

Elective deferrals and after-tax 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 must be permitted to direct that such amounts be invested in alternative investments.

Other contributions

In the case of amounts attributable to contributions other than elective deferrals and after-tax employee contributions (i.e., nonelective employer contributions and employer matching contributions) that are invested in employer securities, an applicable individual who is a participant with three years of service,²⁵¹ a beneficiary of such a participant, or a beneficiary of a deceased participant must be permitted to direct that such amounts be invested in alternative investments.

²⁴⁸ An ESOP will not be treated as failing to be designed to invest primarily in qualifying employer securities merely because the plan provides diversification rights as required under the provision or greater diversification rights than required under the provision.

²⁴⁹ For purposes of ERISA, a one-participant retirement plan is defined as under the provision of ERISA that requires advance notice of a blackout period to be provided to participants and beneficiaries affected by the blackout period, as discussed below.

²⁵⁰ Under section 1372, a two-percent shareholder of an S corporation is treated as a partner for fringe benefit purposes.

²⁵¹ Years of service is defined as under the rules relating to vesting (sec. 411(a)).

A transition rule applies to amounts attributable to these other contributions that are invested in employer securities acquired before the first plan year for which the new 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 is subject to diversification as shown in Table 1, below. The applicable percentage applies separately to each class of employer security in an applicable individual's account. The transition rule does not apply to plan participants who have three years of service and who have attained age 55 by the beginning of the first plan year beginning after December 31, 2005.

Table 1.—Applicable Percentage for Employer Securities Held on Effective Date

Plan year for which diversification applies:	Applicable percentage:
First year	33 percent
Second year	66 percent
Third year	100 percent

The application of the transition rule is illustrated by the following example. Suppose that the account of a participant with at least three years of service held 120 shares of employer common 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 is subject to the diversification requirements. In the second year for which diversification applies, a total of 66 percent of 120 shares of stock (i.e., 79 shares, or an additional 39 shares) is subject to the diversification requirements. In the third year for which diversification applies, 100 percent of the stock, or all 120 shares, is subject to the diversification requirements. In addition, in each year, employer stock in the account attributable to elective deferrals and employee after-tax contributions is fully subject to the diversification requirements, as is any new stock contributed to the account.

Rules relating to the election of investment alternatives

A plan subject to the diversification requirements is required to give applicable individuals a choice of at least three investment options, other than employer securities, each of which is diversified and has materially different risk and return characteristics. It is intended that other investment options generally offered by the plan also must be available to applicable individuals.

A plan does not fail to meet the diversification requirements merely because the plan limits the times when divestment and reinvestment can be made to periodic, reasonable opportunities that occur at least quarterly. It is intended that applicable individuals generally be given the opportunity to make investment changes with respect to employer securities on the same basis as the opportunity to make other investment changes, except in unusual circumstances. Thus, in general, applicable individuals must be given the opportunity to request

changes with respect to investments in employer securities with the same frequency as the opportunity to make other investment changes and that such changes are implemented in the same timeframe as other investment changes, unless circumstances require different treatment.

Except as provided in regulations, a plan may 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). For example, such a restriction or condition includes a provision under which a participant who divests his or her account of employer securities receives less favorable treatment (such as a lower rate of employer contributions) than a participant whose account remains invested in employer securities. On the other hand, such a restriction does not include the imposition of fees with respect to other investment options under the plan, merely because fees are not imposed with respect to investments in employer securities.

Effective Date

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

In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is effective for plan years beginning after the earlier of (1) the later of December 31, 2007, or the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof after the date of enactment), or (2) December 31, 2008.

A special effective date applies with respect to employer matching and nonelective contributions (and earnings thereon) that are invested in employer securities that, as of September 17, 2003: (1) consist of preferred stock; and (2) are held within an ESOP, under the terms of which the value of the preferred stock is subject to a guaranteed minimum. Under the special rule, the diversification requirements apply to such preferred stock for plan years beginning after the earlier of (1) December 31, 2007; or (2) the first date as of which the actual value of the preferred stock equals or exceeds the guaranteed minimum. When the new diversification requirements become effective for the plan under the special rule, the applicable percentage of employer securities held on the effective date that is subject to diversification is determined without regard to the special rule.

**B. Increasing Participation Through Automatic Enrollment Arrangements
(secs. 404(c) and 514 of ERISA and secs. 401(k), 401(m), 414 and 4979 of the Code)**

Present Law

Qualified cash or deferred arrangements—in general

Under present law, most defined contribution plans may include a qualified cash or deferred arrangement (commonly referred to as a “section 401(k)” or “401(k)” plan),²⁵² under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash. Contributions made to the plan at the election of the employee are referred to as “elective deferrals” or “elective contributions”.²⁵³ A 401(k) plan may be designed so that the employee will receive cash unless an affirmative election to make contributions is made. Alternatively, a plan may provide that elective contributions are made at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate). Arrangements that operate in this manner are sometimes referred to as “automatic enrollment” or “negative election” plans. In either case, the employee must have an effective opportunity to elect to receive cash in lieu of contributions.²⁵⁴

Nondiscrimination rules

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the “ADP” test. The ADP test compares the actual deferral percentages (“ADPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee’s deferral percentage generally is the employee’s elective deferrals for the year divided by the employee’s compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the

²⁵² Legally, a section 401(k) plan is not a separate type of plan, but is a profit-sharing, stock bonus, or pre-ERISA money purchase plan that contains a qualified cash or deferred arrangement. The terms “section 401(k) plan” and “401(k) plan” are used here for convenience.

²⁵³ The maximum annual amount of elective deferrals that can be made by an individual is subject to a limit (\$15,000 for 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan, subject to a limit (\$5,000 for 2006).

²⁵⁴ Treasury regulations provide that whether an employee has an effective opportunity to receive cash is based on all the relevant facts and circumstances, including the adequacy of notice of the availability of the election, the period of time during which an election may be made, and any other conditions on elections. Treas. Reg. sec. 1.401(k)-1(e)(2).

nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a “safe harbor section 401(k) plan”). A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each nonhighly compensated employee who is eligible to participate in the arrangement. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee’s elective deferrals up to three percent of compensation and (b) 50 percent of the employee’s elective deferrals from three to five percent of compensation;²⁵⁵ and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees.

Employer matching contributions are also subject to a special nondiscrimination test, the “ACP test,” which compares the average actual contribution percentages (“ACPs”) of matching contributions for the highly compensated employee group and the nonhighly compensated employee group. The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

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

²⁵⁵ In lieu of matching contributions at rates equal to the safe harbor rates, a plan may provide for an alternative match if (1) the rate of the matching contributions does not increase as an employee’s rate of elective deferrals increases and (2) the amount of matching contributions at such rate of elective deferrals is at least equal to the aggregate amount of contributions which would be made if rate of the matching contributions equaled the safe harbor rates.

Top-heavy rules

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

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

Tax-sheltered annuities

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

Erroneous automatic elective contributions

Present law provides special rules for distributions of elective contributions that exceed the amount permitted under the nondiscrimination rules or the dollar limit on such contributions.

Fiduciary rules applicable to default investments of individual account plans

ERISA imposes standards on the conduct of plan fiduciaries, including persons who make investment decisions with respect to plan assets. Fiduciaries are personally liable for any losses to the plan due to a violation of fiduciary standards.

An individual account plan may permit participants to make investment decisions with respect to their accounts. ERISA fiduciary liability does not apply to investment decisions made by plan participants if participants exercise control over the investment of their individual accounts, as determined under ERISA regulations. In that case, a plan fiduciary may be responsible for the investment alternatives made available, but not for the specific investment decisions made by participants.

Preemption of State law

ERISA generally preempts all State laws relating to employee benefit plans, other than generally applicable criminal laws and laws relating to insurance, banking, or securities.

Excess contributions

An excise tax is imposed on an employer making excess contributions or excess aggregate contributions to a qualified retirement plan. Excess contributions are elective contributions, including qualified nonelective contributions and qualified matching contributions that are treated as elective contributions, made to a plan on behalf of highly compensated

employees to the extent that the contributions fail to satisfy the applicable nondiscrimination tests for such plan for the year. Excess aggregate contributions are the aggregate amount of employer matching contributions and employee after-tax contributions to a plan for highly compensated employees to the extent that the contributions fail to satisfy the applicable nondiscrimination tests for such plan for the year.

The excise tax is equal to 10 percent of the excess contributions or excess aggregate contributions under a plan for the plan year ending in the taxable year. The tax does not apply to any excess contributions or excess aggregate contributions that, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within 2½ months after the close of the plan year. Any excess contributions or excess aggregate contributions that are distributed within 2½ months after the close of the plan year are treated as received and earned by the recipient in the taxable year for which such contributions are made. If the total of such distributions to a recipient under a plan for any plan year is less than \$100, such distributions (and any income allocable thereto) are treated as earned and received by the recipient in the taxable year in which the distributions are made.

Additionally, if certain requirements are met, excess contributions may be recharacterized as after-tax employee contributions, no later than 2½ months after the close of the plan year to which the excess contributions relate.²⁵⁶

Explanation of Provision

In general

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

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

Automatic deferral/amount of elective contributions

A qualified automatic enrollment feature must provide that, unless an employee elects otherwise, the employee is treated as making an election to make elective deferrals equal to a stated percentage of compensation not in excess of 10 percent and at least equal to: three percent of compensation for the first year the deemed election applies to the participant; four percent during the second year; five percent during the third year; and six percent during the fourth year and thereafter. The stated percentage must be applied uniformly to all eligible employees.

²⁵⁶ Treas. Reg. sec. 1.401(k)-2(b)(3).

Eligible employees mean all employees eligible to participate in the arrangement, other than employees eligible to participate in the arrangement immediately before the date on which the arrangement became a qualified automatic contribution arrangement with an election in effect (either to participate at a certain percentage or not to participate).

Matching or nonelective contribution requirement

Contributions

An automatic enrollment feature satisfies the contribution requirement if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee's compensation on behalf of each nonhighly compensated employee who is eligible to participate in the automatic enrollment feature. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to 100 percent of the employee's elective deferrals as do not exceed one percent of compensation and 50 percent of the employee's elective deferrals as exceeds one percent but does not exceed six percent of compensation and (2) the rate of match with respect to any elective deferrals for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. It is intended that the provision apply to section 403(b) annuities.

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

Vesting

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

Withdrawal restrictions

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

Notice requirement

Under a notice requirement, each employee eligible to participate in the arrangement must receive notice of the arrangement which is sufficiently accurate and comprehensive to apprise the employee of such rights and obligations and is written in a manner calculated to be understood by the average employee to whom the arrangement applies. The notice must explain: (1) the employee's right under the arrangement to elect not to have elective contributions made on the employee's behalf or to elect to have contributions made in a different amount; and (2) how contributions made under the automatic enrollment arrangement will be invested in the absence of any investment election by the employee. The employee must be given a reasonable period of time after receipt of the notice and before the first election contribution is to be made to make an election with respect to contributions and investments.

Application to tax-sheltered annuities

The new safe harbor rules for automatic contribution plans apply with respect to matching contributions under a section 403(b) annuity through the operation of section 403(b)(12).

Corrective distributions

The provision includes rules under which erroneous automatic contributions may be distributed from the plan no later than 90 days after the date of the first elective contribution with respect to the employee under the arrangement. The amount that is treated as an erroneous contribution is limited to the amount of automatic contributions made during the 90-day period that the employee elects to treat as an erroneous contribution. It is intended that distributions of such amounts are generally treated as a payment of compensation, rather than as a contribution to and then a distribution from the plan. The 10-percent early withdrawal tax does not apply to distributions of erroneous automatic contributions. In addition, it is intended that such contributions are not taken into account for purposes of applying the nondiscrimination rules, or the limit on elective deferrals. Similarly, it is intended that distributions of such contributions are not subject to the otherwise applicable withdrawal restrictions. The rules for corrective distributions apply to distributions from (1) qualified pension plans under Code section 401(a), (2) plans under which amounts are contributed by an individual's employer for Code section 403(b) annuity contract and (3) governmental eligible deferred compensation plans under Code section 457(b).

The corrective distribution rules are not limited to arrangements meeting the requirements of a qualified enrollment feature.

Excess contributions

In the case of an eligible automatic contribution arrangement, the excise tax on excess contributions does not apply to any excess contributions or excess aggregate contributions which, together with income allocable to the contributions, are distributed or forfeited (if forfeitable) within six months after the close of the plan year. Additionally, any excess contributions or excess aggregate contributions (and any income allocable thereto) that are distributed within the period required to avoid application of the excise tax are treated as earned

and received by the recipient in the taxable year in which the distribution is made (regardless of the amount distributed), and the income allocable to excess contributions or excess aggregate contributions that must be distributed is determined through the end of the year for which the contributions were made.

Preemption of State law

The provision preempts any State law that would directly or indirectly prohibit or restrict the inclusion in a plan of an automatic contribution arrangement. The Labor Secretary may establish minimum standards for such arrangements in order for preemption to apply. An automatic contribution arrangement is an arrangement: (1) under which a participant may elect to have the plan sponsor make payments as contributions under the plan on behalf of the participant, or to the participant directly in cash, (2) under which a participant is treated as having elected to have the plan sponsor make such contributions in an amount equal to a uniform percentage of compensation provided under the plan until the participant specifically elects not to have such contributions made (or elects to have contributions made at a different percentage), and (3) under which contributions are invested in accordance with regulations issued by the Secretary of Labor relating to default investments as provided under the bill. The State preemption rules under the bill are not limited to arrangements that meet the requirements of a qualified enrollment feature.

A plan administrator must provide notice to each participant to whom the automatic contribution arrangement applies. If the notice requirement is not satisfied, an ERISA penalty of \$1,100 per day applies.

Effective Date

The provision is effective for years beginning after December 31, 2007. The preemption of conflicting State regulations is effective on the date of enactment. No inference is intended as to the effect of conflicting State regulations prior to date of enactment.

**C. Treatment of Eligible Combined Defined Benefit Plans and
Qualified Cash or Deferred Arrangements
(new sec. 414(x) of the Code and new sec. 210(e) of ERISA)**

Present Law

In general

Under present law, most defined contribution plans may include a qualified cash or deferred arrangement (commonly referred to as a “section 401(k)” or “401(k)” plan),²⁵⁷ under which employees may elect to receive cash or to have contributions made to the plan by the employer on behalf of the employee in lieu of receiving cash (referred to as “elective deferrals” or “elective contributions”).²⁵⁸ A section 401(k) plan may provide that elective deferrals are made for an employee at a specified rate unless the employee elects otherwise (i.e., elects not to make contributions or to make contributions at a different rate), provided that the employee has an effective opportunity to elect to receive cash in lieu of the default contributions. Such a design is sometimes referred to as “automatic enrollment.”

Besides elective deferrals, a section 401(k) plan may provide for: (1) matching contributions, which are employer contributions that are made only if an employee makes elective deferrals; and (2) nonelective contributions, which are employer contributions that are made without regard to whether an employee makes elective deferrals. Under a section 401(k) plan, no benefit other than matching contributions can be contingent on whether an employee makes elective deferrals. Thus, for example, an employee’s eligibility for benefits under a defined benefit pension plan cannot be contingent on whether the employee makes elective deferrals.

A cash balance plan is a defined benefit pension plan with benefits resembling the benefits associated with defined contribution plans. Cash balance plans are sometimes referred to as “hybrid” plans because they combine features of a defined benefit pension plan and a defined contribution plan. Under a cash balance plan, benefits are determined by reference to a hypothetical account balance. An employee’s hypothetical account balance is determined by reference to hypothetical annual allocations to the account (“pay credits”) (e.g., a certain percentage of the employee’s compensation for the year) and hypothetical earnings on the account (“interest credits”). Other types of hybrid plans exist as well, such as so-called “pension equity” plans.

²⁵⁷ Legally, a section 401(k) plan is not a separate type of plan, but is a profit-sharing, stock bonus, or pre-ERISA money purchase plan that contains a qualified cash or deferred arrangement. The terms “section 401(k) plan” and “401(k) plan” are used here for convenience.

²⁵⁸ The maximum annual amount of elective deferrals that can be made by an individual is subject to a dollar limit (\$15,000 for 2006). An individual who has attained age 50 before the end of the taxable year may also make catch-up contributions to a section 401(k) plan, subject to a limit (\$5,000 for 2006).

The assets of a qualified retirement plan (either a defined contribution plan or a defined benefit pension plan) must be held in trust for the exclusive benefit of participants and beneficiaries. Defined benefit pension plans are subject to funding rules, which require employers to make contributions at specified minimum levels.²⁵⁹ In addition, limits apply on the extent to which defined benefit pension plan assets may be invested in employer securities or real property. The minimum funding rules and limits on investments in employer securities or real property generally do not apply to defined contribution plans.

Nondiscrimination requirements

Under a general nondiscrimination requirement, the contributions or benefits provided under a qualified retirement plan must not discriminate in favor of highly compensated employees.²⁶⁰ Treasury regulations provide detailed and exclusive rules for determining whether a plan satisfies the general nondiscrimination rules. Under the regulations, the amount of contributions or benefits provided under the plan and the benefits, rights and features offered under the plan must be tested.

A special nondiscrimination test applies to elective deferrals under a section 401(k) plan, called the actual deferral percentage test or the “ADP” test. The ADP test compares the actual deferral percentages (“ADPs”) of the highly compensated employee group and the nonhighly compensated employee group. The ADP for each group generally is the average of the deferral percentages separately calculated for the employees in the group who are eligible to make elective deferrals for all or a portion of the relevant plan year. Each eligible employee’s deferral percentage generally is the employee’s elective deferrals for the year divided by the employee’s compensation for the year.

The plan generally satisfies the ADP test if the ADP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ADP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ADP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ADP of the nonhighly compensated employee group for the prior plan year.

Under a safe harbor, a section 401(k) plan is deemed to satisfy the special nondiscrimination test if the plan satisfies one of two contribution requirements and satisfies a notice requirement (a “safe harbor section 401(k) plan”). A plan satisfies the contribution requirement under the safe harbor rule if the employer either (1) satisfies a matching contribution requirement or (2) makes a nonelective contribution to a defined contribution plan of at least three percent of an employee’s compensation on behalf of each nonhighly compensated

²⁵⁹ The Pension Benefit Guaranty Corporation generally guarantees a minimum level of benefits under a defined benefit plan.

²⁶⁰ Under special rules, referred to as the permitted disparity rules, higher contributions or benefits can be provided to higher-paid employees in certain circumstances without violating the general nondiscrimination rules.

employee who is eligible to participate in the arrangement. A plan generally satisfies the matching contribution requirement if, under the arrangement: (1) the employer makes a matching contribution on behalf of each nonhighly compensated employee that is equal to (a) 100 percent of the employee's elective deferrals up to three percent of compensation and (b) 50 percent of the employee's elective deferrals from three to five percent of compensation; and (2) the rate of matching contribution with respect to any rate of elective deferrals of a highly compensated employee is not greater than the rate of matching contribution with respect to the same rate of elective deferral of a nonhighly compensated employee.²⁶¹

Employer matching contributions are also subject to a special nondiscrimination test, the "ACP test," which compares the average actual contribution percentages ("ACPs") of matching contributions for the highly compensated employee group and the nonhighly compensated employee group. The plan generally satisfies the ACP test if the ACP of the highly compensated employee group for the current plan year is either (1) not more than 125 percent of the ACP of the nonhighly compensated employee group for the prior plan year, or (2) not more than 200 percent of the ACP of the nonhighly compensated employee group for the prior plan year and not more than two percentage points greater than the ACP of the nonhighly compensated employee group for the prior plan year.

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

Vesting rules

A qualified retirement plan generally must satisfy one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.

Special vesting rules apply to elective deferrals and matching contributions. Elective deferrals must be immediately vested. Matching contributions generally must vest at least as

²⁶¹ Alternatively, matching contributions may be provided at a different rate, provided that: (1) the rate of matching contribution doesn't increase as the rate of elective deferral increases; and (2) the aggregate amount of matching contributions with respect to each rate of elective deferral is not less than the amount that would be provided under the general rule.

rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service. However, matching contributions under a safe harbor section 401(k) plan must be immediately vested.

Top-heavy rules

Under present law, a top-heavy plan is a qualified retirement plan under which cumulative benefits are provided primarily to key employees. An employee is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of a certain amount (\$140,000 for 2006), (2) a five-percent owner, or (3) a one-percent owner with compensation in excess of \$150,000. A plan that is top-heavy must provide (1) minimum employer contributions or benefits to participants who are not key employees and (2) more rapid vesting for participants who are not key employees (as discussed below).

In the case of a defined contribution plan, the minimum contribution is the lesser of (1) three percent of compensation, or (2) the highest percentage of compensation at which contributions were made for any key employee. In the case of a defined benefit pension, the minimum benefit is the lesser of (1) two percent of average compensation multiplied by the participant's years of service, or (2) 20 percent of average compensation. For this purpose, a participant's average compensation is generally average compensation for the consecutive-year period (not exceeding five years) during which the participant's aggregate compensation is the greatest.

Top-heavy plans must satisfy one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of contributions or benefits upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of contributions or benefits for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.²⁶²

A safe harbor section 401(k) plan is not subject to the top-heavy rules, provided that, if the plan provides for matching contributions, it must also satisfy the matching contribution safe harbor.

Other qualified retirement plan requirements

Qualified retirement plans are subject to various other requirements, some of which depend on whether the plan is a defined contribution plan or a defined benefit pension. Such requirements include limits on contributions and benefits and spousal protections.

²⁶² The top-heavy vesting schedules are the same as the vesting schedules that apply to matching contributions.

In the case of a defined contribution plan, annual additions with respect to each plan participant cannot exceed the lesser of: (1) 100 percent of the participant's compensation; or (2) a dollar amount, indexed for inflation (\$44,000 for 2006). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. In the case of a defined benefit pension, annual benefits payable under the plan generally may not exceed the lesser of: (1) 100 percent of average compensation; or (2) a dollar amount, indexed for inflation (\$175,000 for 2006).

Defined benefit pension plans are required to provide benefits in the form of annuity unless the participant (and his or her spouse, in the case of a married participant) consents to another form of benefit. In addition, in the case of a married participant, benefits generally must be paid in the form of a qualified joint and survivor annuity ("QJSA") unless the participant and his or her spouse consent to a distribution in another form. 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. These spousal protection requirements generally do not apply to a defined contribution plan that does not offer annuity distributions.

Annual reporting by qualified retirement plans

The plan administrator of a qualified retirement plan generally must file an annual return with the Secretary of the Treasury and an annual report with the Secretary of Labor. In addition, in the case of a defined benefit pension, certain information is generally required to be filed with the Pension Benefit Guaranty Corporation ("PBGC"). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

The Form 5500 is due by the last day of the seventh month following the close of the plan year. The due date may be extended up to two and one-half months. Copies of filed Form 5500s are available for public examination at the U.S. Department of Labor.

A plan administrator must automatically provide participants with a summary of the annual report within two months after the due date of the annual report (i.e., by the end of the ninth month after the end of the plan year unless an extension applies). In addition, a copy of the full annual report must be provided to participants on written request.

Explanation of Provision

In general

The provision provides rules for an "eligible combined plan." An eligible combined plan is a plan: (1) that is maintained by an employer that is a small employer at the time the plan is established; (2) that consists of a defined benefit plan and an "applicable" defined contribution plan; (3) the assets of which are held in a single trust forming part of the plan and are clearly identified and allocated to the defined benefit plan and the applicable defined contribution plan to the extent necessary for the separate application of the Code and ERISA; and (4) that meets

certain benefit, contribution, vesting and nondiscrimination requirements as discussed below. For this purpose, an applicable defined contribution plan is a defined contribution plan that includes a qualified cash or deferred arrangement (i.e., a section 401(k) plan). A small employer is an employer that employed an average of at least two, but not more than 500, employees on business days during the preceding calendar year and at least two employees on the first day of the plan year.

Except as specified in the provision, the provisions of the Code and ERISA are applied to any defined benefit plan and any applicable defined contribution plan that are part of an eligible combined plan in the same manner as if each were not part of the eligible combined plan. Thus, for example, the present-law limits on contributions and benefits apply separately to contributions under an applicable defined contribution plan that is part of an eligible combined plan and to benefits under the defined benefit plan that is part of the eligible combined plan. In addition, the spousal protection rules apply to the defined benefit plan, but not to the applicable defined contribution plan except to the extent provided under present law. Moreover, although the assets of an eligible combined plan are held in a single trust, the funding rules apply to a defined benefit plan that is part of an eligible combined plan on the basis of the assets identified and allocated to the defined benefit, and the limits on investing defined benefit plan assets in employer securities or real property apply to such assets. Similarly, separate participant accounts are required to be maintained under the applicable defined contribution plan that is part of the eligible combined plan, and earnings (or losses) on participants' account are based on the earnings (or losses) with respect to the assets of the applicable defined contribution plan.

Requirements with respect to defined benefit plan

A defined benefit plan that is part of an eligible combined plan is required to provide each participant with a benefit of not less than the applicable percentage of the participant's final average pay. The applicable percentage is the lesser of: (1) one percent multiplied by the participant's years of service; or (2) 20 percent. For this purpose, final average pay is determined using the consecutive-year period (not exceeding five years) during which the participant has the greatest aggregate compensation.

If the defined benefit plan is an applicable defined benefit plan,²⁶³ the plan is treated as meeting this benefit requirement if each participant receives a pay credit for each plan year of not less than the percentage of compensation determined in accordance with the following table:

²⁶³ Applicable defined benefit plan is defined as under the TITLE VII of the bill.

Table 2.–Percentage of Compensation

Participant's age as of the beginning of the plan year:	Percentage:
30 or less	2 percent
Over 30 but less than 40	4 percent
Over 40 but less than 50	6 percent
50 or over	8 percent

A defined benefit that is part of an eligible combined plan must provide the required benefit to each participant, regardless of whether the participant makes elective deferrals to the applicable defined contribution plan that is part of the eligible combined plan.

Any benefits provided under the defined benefit plan (including any benefits provided in addition to required benefits) must be fully vested after three years of service.

Requirements with respect to applicable defined contribution plan

Certain automatic enrollment and matching contribution requirements must be met with respect to an applicable defined contribution plan that is part of an eligible combined plan. First, the qualified cash or deferred arrangement under the plan must constitute an automatic contribution arrangement, under which each employee eligible to participate is treated as having elected to make deferrals of four percent of compensation unless the employee elects otherwise (i.e., elects not to make deferrals or to make deferrals at a different rate). Participants must be given notice of their right to elect otherwise and must be given a reasonable period of time after receiving notice in which to make an election. In addition, participants must be given notice of their rights and obligations within a reasonable period before each year.

Under the applicable defined contribution plan, the employer must be required to make matching contributions on behalf of each employee eligible to participate in the arrangement in an amount equal to 50 percent of the employee's elective deferrals up to four percent of compensation, and the rate of matching contribution with respect to any elective deferrals for highly compensated employees must not be not greater than the rate of match for nonhighly compensated employees.²⁶⁴ Matching contributions in addition to the required matching contributions may also be made. The employer may also make nonelective contributions under the applicable defined contribution plan, but any nonelective contributions are not taken into account in determining whether the matching contribution requirement is met.

²⁶⁴ As under present law, matching contributions may be provided at a different rate, provided that: (1) the rate of matching contribution doesn't increase as the rate of elective deferral increases; and (2) the aggregate amount of matching contributions with respect to each rate of elective deferral is not less than the amount that would be provided under the general rule.

Any matching contributions under the applicable defined contribution plan (including any in excess of required matching contributions) must be fully vested when made. Any nonelective contributions made under the applicable defined contribution plan must be fully vested after three years of service.

Nondiscrimination and other rules

An applicable defined contribution plan satisfies the ADP test on a safe-harbor basis. Matching contributions under an applicable defined contribution plan must satisfy the ACP test or may satisfy the matching contribution safe harbor under present law, as modified to reflect the matching contribution requirements applicable under the provision.

Nonelective contributions under an applicable defined contribution plan and benefits under a defined benefit plan that are part of an eligible combined plan are generally subject to the nondiscrimination rules as under present law. However, neither a defined benefit plan nor an applicable defined contribution plan that is part of an eligible combined plan may be combined with another plan in determining whether the nondiscrimination requirements are met.²⁶⁵

An applicable defined contribution plan and a defined benefit plan that are part of an eligible combined plan are treated as meeting the top-heavy requirements.

All contributions, benefits, and other rights and features that are provided under a defined benefit plan or an applicable defined contribution plan that is part of an eligible combined plan must be provided uniformly to all participants. This requirement applies regardless of whether nonuniform contributions, benefits, or other rights or features could be provided without violating the nondiscrimination rules. However, it is intended that a plan will not violate the uniformity requirement merely because benefits accrued for periods before a defined benefit or defined contribution plan became part of an eligible combined plan are protected (as required under the anticutback rules).

Annual reporting

An eligible combined plan is treated as a single plan for purposes of annual reporting. Thus, only a single Form 5500 is required. All of the information required under present law with respect to a defined benefit plan or a defined contribution plan must be provided in the Form 5500 for the eligible combined plan. In addition, only a single summary annual report must be provided to participants.

Other rules

The provision of the bill relating to default investment options and the preemption of State laws with respect to automatic enrollment arrangements are applicable to eligible combined

²⁶⁵ The permitted disparity rules do not apply in determining whether an applicable defined contribution plan or a defined benefit plan that is part of an eligible combined plan satisfies (1) the contribution or benefit requirements under the provision or (2) the nondiscrimination requirements.

plans. It is intended that in the case that an eligible combined plan terminates, the PBGC guarantee applies only to benefits under the defined benefit portion of the plan.

Effective Date

The provision is effective for plan years beginning after December 31, 2009.

**D. Faster Vesting of Employer Nonelective Contributions
(sec. 203 of ERISA, and sec. 411 of the Code)**

Present Law

Under present law, in general, a plan is not a qualified plan unless a participant's employer-provided benefit vests at least as rapidly as under one of two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the completion of five years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after three years of service, 40 percent after four years of service, 60 percent after five years of service, 80 percent after six years of service, and 100 percent after seven years of service.²⁶⁶

Faster vesting schedules apply to employer matching contributions. Employer matching contributions are required to vest at least as rapidly as under one of the following two alternative minimum vesting schedules. A plan satisfies the first schedule if a participant acquires a nonforfeitable right to 100 percent of employer matching contributions upon the completion of three years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to 20 percent of employer matching contributions for each year of service beginning with the participant's second year of service and ending with 100 percent after six years of service.

Explanation of Provision

The provision applies the present-law vesting schedule for matching contributions to all employer contributions to defined contribution plans.

The provision does not apply to any employee until the employee has an hour of service after the effective date. In applying the new vesting schedule, service before the effective date is taken into account.

Effective Date

The provision is generally effective for contributions for plan years beginning after December 31, 2006.

In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision is not effective for contributions (including allocations of forfeitures) for plan years beginning before the earlier of (1) the later of the date on which the last of such collective bargaining agreements terminates (determined without regard to any extension thereof on or after the date of enactment) or January 1, 2007, or (2) January 1, 2009.

²⁶⁶ The minimum vesting requirements are also contained in Title I of the Employee Retirement Income Security Act of 1974 ("ERISA").

In the case of an employee stock ownership plan (“ESOP”) which on September 26, 2005, had outstanding a loan incurred for the purpose of acquiring qualifying employer securities, the provision does not apply to any plan year beginning before the earlier of (1) the date on which the loan is fully repaid, or (2) the date on which the loan was, as of September 26, 2005, scheduled to be fully repaid.

E. Distributions During Working Retirement
(sec. 3(2) of ERISA and new sec. 401(a)(35) of the Code)

Present Law

Under ERISA, a pension plan is a plan, fund, or program established or maintained by an employer or an employee organization, or by both, to the extent that, by its express terms or surrounding circumstances, the plan, fund, or program: (1) provides retirement income to employees, or (2) results in a deferral of income by employees for periods extending to the termination of covered employment or beyond, regardless of the method of calculating contributions made to or benefits under the plan or the method of distributing benefits from the plan.

For purposes of the qualification requirements applicable to pension plans, stock bonus plans, and profit-sharing plans under the Code, a pension plan is a plan established and maintained primarily to provide systematically for the payment of definitely determinable benefits to employees over a period of years, usually life, after retirement.²⁶⁷ A pension plan (i.e., a defined benefit plan or money purchase pension plan) may not provide for distributions before the attainment of normal retirement age (commonly age 65) to participants who have not separated from employment.²⁶⁸

Under proposed regulations, in the case of a phased retirement program, a pension plan is permitted to pay a portion of a participant's benefits before attainment of normal retirement age.²⁶⁹ A phased retirement program is a program under which employees who are at least age 59½ and are eligible for retirement may reduce (by at least 20 percent) the number of hours they customarily work and receive a pro rata portion of their retirement benefits, based on the reduction in their work schedule.

Explanation of Provision

Under the provision, for purposes of the definition of pension plan under ERISA, a distribution from a plan, fund, or program is not treated as made in a form other than retirement income or as a distribution prior to termination of covered employment solely because the distribution is made to an employee who has attained age 62 and who is not separated from employment at the time of such distribution.

In addition, under the Code, a pension plan does not fail to be a qualified retirement plan solely because the plan provides that a distribution may be made to an employee who has attained age 62 and who is not separated from employment at the time of the distribution.

²⁶⁷ Treas. Reg. sec. 1.401-1(b)(1)(i).

²⁶⁸ See, e.g., Rev. Rul. 74-254.

²⁶⁹ Prop. Treas. Reg. secs. 1.401(a)-1(b)(1)(iv) and 1.401(a)-3.

Effective Date

The provision is effective for distributions in plan years beginning after December 31, 2006.

**F. Treatment of Plans Maintained by Indian Tribes
(sec. 414(d) of the Code and sec. 3(32) of ERISA)**

Present Law

Governmental plans are exempt from ERISA and from Code requirements that correspond to ERISA requirements, such as the vesting rules and the funding rules. A governmental plan is generally a plan established and maintained for its employees by (1) the Federal government, (2) the government of a State or political subdivision of a State, or (3) any agency or instrumentality of any of the foregoing.

Benefits under a defined benefit pension plan generally cannot exceed the lesser of (1) 100 percent of average compensation, or (2) a dollar amount (\$175,000 for 2006), subject to certain special rules for defined benefit plans maintained by State and local government employers and other special rules for employees of a police or fire department. Employee contributions to a defined benefit pension plan are generally subject to tax; however, employee contributions may be made to a State or local government defined benefit pension plan on a pretax basis (referred to as “pickup” contributions).

Governmental defined benefit pension plans are not covered by the PBGC insurance program.

Explanation of Provision

Under the provision, the term “governmental plan” for purposes of section 414 of the Code, section 3(32) of ERISA, and the PBGC termination insurance program includes a plan: (1) which is established and maintained by an Indian tribal government (as defined in Code sec. 7701(a)(40)), a subdivision of an Indian tribal government (determined in accordance with Code sec. 7871(d)), or an agency or instrumentality of either; and (2) all of the participants of which are qualified employees of such entity. A qualified employee is an employee of an entity described in (1) all of whose services for such entity are in the performance of essential governmental services and not in the performance of commercial activities (whether or not such activities are an essential governmental function). Thus, for example, a governmental plan would include a plan of a tribal government all of the participants of which are teachers in tribal schools. On the other hand, a governmental plan would not include a plan covering tribal employees who are employed by a hotel, casino, service station, convenience store, or marina operated by a tribal government.

Under the provision, the special benefit limitations applicable to employees of police and fire departments of a State or political subdivision (Code sec. 415(b)(2)(H)) apply to such employees of an Indian tribe or any political subdivision thereof. In addition, the rules relating to pick up contribution under governmental plans (Code sec. 414(h)) and special benefit limitations for governmental plans (sec. 415(b)(10)) apply to tribal plans treated as governmental plans under the provision.

Effective Date

The provision is effective for plan years beginning on or after the date of enactment.

TITLE X: SPOUSAL PENSION PROTECTION

A. Regulations on Time and Order of Issuance of Domestic Relations Orders

Present Law

Benefits provided under a qualified retirement plan for a participant may not be assigned or alienated to creditors of the participant, except in very limited circumstances.²⁷⁰ One exception to the prohibition on assignment or alienation is a qualified domestic relations order (“QDRO”).²⁷¹ A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee, including a former spouse, to any plan benefit payable with respect to a participant and that meets certain procedural requirements. In addition, a QDRO generally may not require the plan to provide any type or form of benefit, or any option, not otherwise provided under the plan, or to provide increased benefits.

Present law also provides that a QDRO may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under a domestic relations order previously determined to be a QDRO. This rule implicitly recognizes that a domestic relations order issued after a QDRO may also qualify as a QDRO. However, present law does not otherwise provide specific rules for the treatment of a domestic relations order as a QDRO if the order is issued after another domestic relations order or a QDRO (including an order issued after a divorce decree) or revises another domestic relations order or a QDRO.

Present law provides specific rules that apply during any period in which the status of a domestic relations order as a QDRO is being determined (by the plan administrator, by a court, or otherwise). During such a period, the plan administrator is required to account separately for the amounts that would have been payable to the alternate payee during the period if the order had been determined to be a QDRO (referred to as “segregated amounts”). If, within the 18-month period beginning with the date on which the first payment would be required to be made under the order, the order (or modification thereof) is determined to be a QDRO, the plan administrator is required to pay the segregated amounts (including any interest thereon) to the person or persons entitled thereto. If, within the 18-month period, the order is determined not to be a QDRO, or its status as a QDRO is not resolved, the plan administrator is required to pay the segregated amounts (including any interest) to the person or persons who would be entitled to such amounts if there were no order. In such a case, any subsequent determination that the order is a QDRO is applied prospectively only.

Explanation of Provision

The Secretary of Labor is directed to issue, not later than one year after the date of enactment of the provision, regulations to clarify the status of certain domestic relations orders. In particular, the regulations are to clarify that a domestic relations order otherwise meeting the

²⁷⁰ Code sec. 401(a)(13); ERISA sec. 206(d).

²⁷¹ Code secs. 401(a)(13)(B) and 414(p); ERISA sec. 206(d)(3).

QDRO requirements will not fail to be treated as a QDRO solely because of the time it is issued or because it is issued after or revises another domestic relations order or QDRO. The regulations are also to clarify that such a domestic relations order is in all respects subject to the same requirements and protections that apply to QDROs. For example, as under present law, such a domestic relations order may not require the payment of benefits to an alternate payee that are required to be paid to another alternate payee under an earlier QDRO. In addition, the present-law rules regarding segregated amounts that apply while the status of a domestic relations order as a QDRO is being determined continue to apply.

Effective Date

The provision is effective on the date of enactment.

**B. Benefits Under the Railroad Retirement System for Former Spouses
(secs. 2 and 5 of the Railroad Retirement Act of 1974)**

Present Law

In general

The Railroad Retirement System has two main components. Tier I of the system is financed by taxes on employers and employees equal to the Social Security payroll tax and provides qualified railroad retirees (and their qualified spouses, dependents, widows, or widowers) with benefits that are roughly equal to Social Security. Covered railroad workers and their employers pay the Tier I tax instead of the Social Security payroll tax, and most railroad retirees collect Tier I benefits instead of Social Security. Tier II of the system replicates a private pension plan, with employers and employees contributing a certain percentage of pay toward the system to finance defined benefits to eligible railroad retirees (and qualified spouses, dependents, widows, or widowers) upon retirement; however, the Federal Government collects the Tier II payroll contribution and pays out the benefits.

Former spouses of living railroad employees

Generally, a former spouse of a railroad employee who is otherwise eligible for any Tier I or Tier II benefit cannot receive either benefit until the railroad employee actually retires and begins receiving his or her retirement benefits. This is the case regardless of whether a State divorce court has awarded such railroad retirement benefits to the former spouse.

Former spouses of deceased railroad employees

The former spouse of a railroad employee may be eligible for survivors' benefits under Tier I of the Railroad Retirement System. However, a former spouse loses eligibility for any otherwise allowable Tier II benefits upon the death of the railroad employee.

Explanation of Provision

Former spouses of living railroad employees

The provision eliminates the requirement that a railroad employee actually receive railroad retirement benefits for the former spouse to be entitled to any Tier I benefit or Tier II benefit awarded under a State divorce court decision.

Former spouses of deceased railroad employees

The provision provides that a former spouse of a railroad employee does not lose eligibility for otherwise allowable Tier II benefits upon the death of the railroad employee.

Effective Date

The provision is effective one year after the date of enactment.

**C. Requirement for Additional Survivor Annuity Option
(sec. 417 of the Code and sec. 205 of ERISA)**

Present Law

Defined benefit pension plans and money purchase pension plans are required to provide benefits 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.²⁷² In the case of a married participant who dies before the commencement of retirement benefits, the surviving spouse must be provided with a qualified preretirement survivor annuity (“QPSA”), which must provide the surviving spouse with a benefit that is not less than the benefit that would have been provided under the survivor portion of a QJSA.

The participant and his or her spouse may waive the right to a QJSA and QPSA provided certain requirements are satisfied. In general, these conditions include providing the participant with a written explanation of the terms and conditions of the survivor annuity, the right to make, and the effect of, a waiver of the annuity, the rights of the spouse to waive the survivor annuity, and the right of the participant to revoke the waiver. In addition, the spouse must provide a written consent to the waiver, witnessed by a plan representative or a notary public, which acknowledges the effect of the waiver.

Defined contribution plans other than money purchase pension plans are not required to provide a QJSA or QPSA if the participant does not elect an annuity as the form of payment, the surviving spouse is the beneficiary of the participant’s entire vested account balance under the plan (unless the spouse consents to designation of another beneficiary),²⁷³ and, with respect to the participant, the plan has not received a transfer from a plan to which the QJSA and QPSA requirements applied (or separately accounts for the transferred assets). In the case of a defined contribution plan subject to the QJSA and QPSA requirements, a QPSA means an annuity for the life of the surviving spouse that has an actuarial value of at least 50 percent of the participant’s vested account balance as of the date of death.

Explanation of Provision

The provision revises the minimum survivor annuity requirements to require that, at the election of the participant, benefits will be paid in the form of a “qualified optional survivor annuity.” A qualified optional survivor annuity means an annuity for the life of the participant

²⁷² Thus, for example, a QJSA could consist of an annuity for the life of the participant, with a survivor annuity for the life of the spouse equal to 75 percent of the amount of the annuity payable during the joint lives of the participant and his or her spouse.

²⁷³ Waiver and election rules apply to the waiver of the right of the spouse to be the beneficiary under a defined contribution plan that is not required to provide a QJSA.

with a survivor annuity for the life of the spouse which is equal to the applicable percentage of the amount of the annuity that is: (1) payable during the joint lives of the participant and the spouse; and (2) the actuarial equivalent of a single annuity for the life of the participant.

If the survivor annuity provided by the QJSA under the plan is less than 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 75 percent. If the survivor annuity provided by the QJSA under the plan is greater than or equal to 75 percent of the annuity payable during the joint lives of the participant and spouse, the applicable percentage is 50 percent. Thus, for example, if the survivor annuity provided by the QJSA under the plan is 50 percent, the survivor annuity provided under the qualified optional survivor annuity must be 75 percent.

The written explanation required to be provided to participants explaining the terms and conditions of the qualified joint and survivor annuity must also include the terms and conditions of the qualified optional survivor annuity.

Under the provision of the bill relating to plan amendments, a plan amendment made pursuant to a provision of the bill generally will not violate the anticutback rule if certain requirements are met. Thus, a plan is not treated as having decreased the accrued benefit of a participant solely by reason of the adoption of a plan amendment pursuant to the provision requiring that the plan offer a qualified optional survivor annuity. The elimination of a subsidized QJSA is not protected by the anticutback provision in the bill unless an equivalent or greater subsidy is retained in one of the forms offered under the plan as amended. For example, if a plan that offers a subsidized 50 percent QJSA is amended to provide an unsubsidized 50 percent QJSA and an unsubsidized 75 percent joint and survivor annuity as its qualified optional survivor annuity, the replacement of the subsidized 50 percent QJSA with the unsubsidized 50 percent QJSA is not protected by the anticutback protection.

Effective Date

The provision applies generally to plan years beginning after December 31, 2007. In the case of a plan maintained pursuant to one or more collective bargaining agreements, the provision applies to plan years beginning on or after the earlier of (1) the later of January 1, 2008, and the last date on which an applicable collective bargaining agreement terminates (without regard to extensions), and (2) January 1, 2009.

TITLE XI: ADMINISTRATIVE PROVISIONS

A. Updating of Employee Plans Compliance Resolution System

Present Law

Tax-favored treatment is provided to various retirement savings arrangements that meet certain requirements under the Code, including qualified retirement plans and annuities (secs. 401(a) and 403(a)), tax-sheltered annuities (sec. 403(b)), simplified employee pensions (“SEPs”) (sec. 408(k)), and SIMPLE IRAs (sec. 408(p)). The Internal Revenue Service (“IRS”) has established the Employee Plans Compliance Resolution System (“EPCRS”), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended to satisfy the requirements of section 401(a), section 403(a), section 403(b), section 408(k), or section 408(p), as applicable. The IRS has updated and expanded EPCRS several times.²⁷⁴

EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis. EPCRS is based on the following general principles:

- Plans sponsors and administrators should be encouraged to establish administrative practices and procedures that ensure that plans are operated properly in accordance with applicable Code requirements;
- Plans sponsors and administrators should satisfy applicable plan document requirements;
- Plans sponsors and administrators should make voluntary and timely correction of any plan failures, whether involving discrimination in favor of highly compensated employees, plan operations, the terms of the plan document, or adoption of a plan by an ineligible employer; timely and efficient correction protects participating employees by providing them with their expected retirement benefits, including favorable tax treatment;
- Voluntary compliance is promoted by providing for limited fees for voluntary corrections approved by the Service, thereby reducing employers’ uncertainty regarding their potential tax liability and participants’ potential tax liability;
- Fees and sanctions should be graduated in a series of steps so that there is always an incentive to correct promptly;
- Sanctions for plan failures identified on audit should be reasonable in light of the nature, extent, and severity of the violation;
- Administration of EPCRS should be consistent and uniform; and

²⁷⁴ See Rev. Proc. 2006-27, 2006-22 IRB 945.

- Sponsors should be able to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their plans.

The components of EPCRS provide for self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program (“SCP”) generally permits a plan sponsor that has established compliance practices and procedures to correct certain insignificant failures at any time (including during an audit), and certain significant failures generally within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program (“VCP”) permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program (“Audit CAP”) provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

Explanation of Provision

The provision clarifies that the Secretary has the full authority to establish and implement EPCRS (or any successor program) and any other employee plans correction policies, including the authority to waive income, excise or other taxes to ensure that any tax, penalty or sanction is not excessive and bears a reasonable relationship to the nature, extent and severity of the failure.

Under the provision, the Secretary of the Treasury is directed to continue to update and improve EPCRS (or any successor program), giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special concerns and circumstances that small employers face with respect to compliance and correction of compliance failures, (3) extending the duration of the self-correction period under SCP for significant compliance failures, (4) expanding the availability to correct insignificant compliance failures under SCP during audit, and (5) assuring that any tax, penalty, or sanction that is imposed by reason of a compliance failure is not excessive and bears a reasonable relationship to the nature, extent, and severity of the failure.

Effective Date

The provision is effective on the date of enactment.

**B. Notice and Consent Period Regarding Distributions
(sec. 417(a) of the Code, and sec. 205(c) of ERISA)**

Present Law

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements apply to the participant.

If the present value of the participant's vested accrued benefit exceeds \$5,000,²⁷⁵ the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right to defer the receipt of a distribution, or, as applicable, to have the distribution directly transferred to another retirement plan or individual retirement arrangement ("IRA"), and (3) the rules concerning taxation of a distribution. If the joint and survivor annuity requirements are applicable, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.²⁷⁶

Explanation of Provision

Under the provision, a qualified retirement plan is required to provide the applicable distribution notice no less than 30 days and no more than 180 days before the date distribution commences. The Secretary of the Treasury is directed to modify the applicable regulations to reflect the extension of the notice period to 180 days and to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt.

Effective Date

The provision and the modifications required to be made under the provision apply to years beginning after December 31, 2006. In the case of a description of the consequences of a

²⁷⁵ The portion of a participant's benefit that is attributable to amounts rolled over from another plan may be disregarded in determining the present value of the participant's vested accrued benefit.

²⁷⁶ Code sec. 417(a)(6)(A); ERISA sec. 205(c)(7)(A); Treas. Reg. secs. 1.402(f)-1, 1.411(a)-11(c), and 1.417(e)-1(b).

participant's failure to defer receipt of a distribution that is made before the date 90 days after the date on which the Secretary of the Treasury makes modifications to the applicable regulations, the plan administrator is required to make a reasonable attempt to comply with the requirements of the provision.

C. Pension Plan Reporting Simplification

Present Law

The plan administrator of a pension plan generally must file an annual return with the Secretary of the Treasury, an annual report with the Secretary of Labor, and certain information with the Pension Benefit Guaranty Corporation (“PBGC”). Form 5500, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 with the Department of Labor.

The Form 5500 series consists of 2 different forms: Form 5500 and Form 5500-EZ. Form 5500 is the more comprehensive of the forms and requires the most detailed financial information. The plan administrator of a “one-participant plan” generally may file Form 5500-EZ. For this purpose, a plan is a one-participant plan if: (1) the only participants in the plan are the sole owner of a business that maintains the plan (and such owner’s spouse), or partners in a partnership that maintains the plan (and such partners’ spouses);²⁷⁷ (2) the plan is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b); (3) the plan does not provide benefits to anyone other than the sole owner of the business (or the sole owner and spouse) or the partners in the business (or the partners and spouses); (4) the employer is not a member of a related group of employers; and (5) the employer does not use the services of leased employees. In addition, the plan administrator of a one-participant plan is not required to file a return if the plan does not have an accumulated funding deficiency and the total value of the plan assets as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed \$100,000.

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

Explanation of Provision

The Secretary of the Treasury is directed to modify the annual return filing requirements with respect to a one-participant plan to provide that if the total value of the plan assets of such a plan as of the end of the plan year does not exceed \$250,000, the plan administrator is not required to file a return. In addition, the Secretary of the Treasury and the Secretary of Labor are directed to provide simplified reporting requirements for plan years beginning after December 31, 2006, for certain plans with fewer than 25 participants.

²⁷⁷ Under Department of Labor regulations, certain business owners and their spouses are not treated as employees. 29 C.F.R. sec. 2510.3-3(c) (2006). Thus, plans covering only such individuals are not subject to ERISA.

Effective Date

The provision relating to one-participant retirement plans is effective for plan years beginning on or after January 1, 2007. The provision relating to simplified reporting for plans with fewer than 25 participants is effective on the date of enactment.

**D. Voluntary Early Retirement Incentive and Employment Retention Plans
Maintained by Local Educational Agencies and Other Entities
(secs. 457(e)(11) and 457(f) of the Code,
sec. 3(2)(B) of ERISA, and sec. 4(l)(1) of the ADEA)**

Present Law

Eligible deferred compensation plans of State and local governments and tax-exempt employers

A “section 457 plan” is an eligible deferred compensation plan of a State or local government or tax-exempt employer that meets certain requirements. For example, the amount that can be deferred annually under section 457 cannot exceed a certain dollar limit (\$14,000 for 2005). Amounts deferred under a section 457 plan are generally includible in gross income when paid or made available (or, in the case of governmental section 457 plans, when paid). Subject to certain exceptions, amounts deferred under a plan that does not comply with section 457 (an “ineligible plan”) are includible in income when the amounts are not subject to a substantial risk of forfeiture. Section 457 does not apply to any bona fide vacation leave, sick leave, compensatory time, severance pay, disability pay, or death benefit plan. Additionally, section 457 does not apply to qualified retirement plans or qualified governmental excess benefit plans that provide benefits in excess of those that are provided under a qualified retirement plan maintained by the governmental employer.

ERISA

ERISA provides rules governing the operation of most employee benefit plans. The rules to which a plan is subject depend on whether the plan is an employee welfare benefit plan or an employee pension benefit plan. For example, employee pension benefit plans are subject to reporting and disclosure requirements, participation and vesting requirements, funding requirements, and fiduciary provisions. Employee welfare benefit plans are not subject to all of these requirements. Governmental plans are exempt from ERISA.

Age Discrimination in Employment Act

The Age Discrimination in Employment Act (“ADEA”) generally prohibits discrimination in employment because of age. However, certain defined benefit pension plans may lawfully provide payments that constitute the subsidized portion of an early retirement benefit or social security supplements pursuant to ADEA²⁷⁸, and employers may lawfully provide a voluntary early retirement incentive plan that is consistent with the purposes of ADEA.²⁷⁹

²⁷⁸ See ADEA sec. 4(l)(1).

²⁷⁹ See ADEA sec. 4(f)(2).

Explanation of Provision

Early retirement incentive plans of local educational agencies and education associations

In general

The provision addresses the treatment of certain voluntary early retirement incentive plans under section 457, ERISA, and ADEA.

Code section 457

Under the provision, special rules apply under section 457 to a voluntary early retirement incentive plan that is maintained by a local educational agency or a tax-exempt education association which principally represents employees of one or more such agencies and that makes payments or supplements as an early retirement benefit, a retirement-type subsidy, or a social security supplement in coordination with a defined benefit pension plan maintained by a State or local government or by such an association. Such a voluntary early retirement incentive plan is treated as a bona fide severance plan for purposes of section 457, and therefore is not subject to the limits under section 457, to the extent the payments or supplements could otherwise be provided under the defined benefit pension plan. For purposes of the provision, the payments or supplements that could otherwise be provided under the defined benefit pension plan are to be determined by applying the accrual and vesting rules for defined benefit pension plans.²⁸⁰

ERISA

Under the provision, voluntary early retirement incentive plans (as described above) are treated as welfare benefit plans for purposes of ERISA (other than governmental plans that are exempt from ERISA).

ADEA

The provision also addresses the treatment under ADEA of voluntary early retirement incentive plans that are maintained by local educational agencies and tax-exempt education associations which principally represent employees of one or more such agencies, and that make payments or supplements that constitute the subsidized portion of an early retirement benefit or a social security supplement and that are made in coordination with a defined benefit pension plan maintained by a State or local government or by such an association. For purposes of ADEA, such a plan is treated as part of the defined benefit pension plan and the payments or supplements under the plan are not severance pay that may be subject to certain deductions under ADEA.

²⁸⁰ The accrual and vesting rules have the effect of limiting the social security supplements and early retirement benefits that may be provided under a defined benefit pension plan; however, government plans are exempt from these rules.

Employment retention plans of local educational agencies and education associations

The provision addresses the treatment of certain employment retention plans under section 457 and ERISA. The provision applies to employment retention plans that are maintained by local educational agencies or tax-exempt education associations which principally represent employees of one or more such agencies and that provide compensation to an employee (payable on termination of employment) for purposes of retaining the services of the employee or rewarding the employee for service with educational agencies or associations.

Under the provision, special tax treatment applies to the portion of an employment retention plan that provides benefits that do not exceed twice the applicable annual dollar limit on deferrals under section 457 (\$14,000 for 2005). The provision provides an exception from the rules under section 457 for ineligible plans with respect to such portion of an employment retention plan. This exception applies for years preceding the year in which benefits under the employment retention plan are paid or otherwise made available to the employee. In addition, such portion of an employment retention plan is not treated as providing for the deferral of compensation for tax purposes.

Under the provision, an employment retention plan is also treated as a welfare benefit plan for purposes of ERISA (other than a governmental plan that is exempt from ERISA).

Effective Date

The provision is generally effective on the date of enactment. The amendments to section 457 apply to taxable years ending after the date of enactment. The amendments to ERISA apply to plan years ending after the date of enactment. Nothing in the provision alters or affects the construction of the Code, ERISA, or ADEA as applied to any plan, arrangement, or conduct to which the provision does not apply.

**E. No Reduction in Unemployment Compensation as a Result of Pension Rollovers
(sec. 3304(a)(15) of the Code)**

Present Law

Under present law, unemployment compensation payable by a State to an individual generally is reduced by the amount of retirement benefits received by the individual. Distributions from certain employer-sponsored retirement plans or IRAs that are transferred to a similar retirement plan or IRA (“rollover distributions”) generally are not includible in income. Some States currently reduce the amount of an individual’s unemployment compensation by the amount of a rollover distribution.

Explanation of Provision

The provision amends the Code so that the reduction of unemployment compensation payable to an individual by reason of the receipt of retirement benefits does not apply in the case of a rollover distribution.

Effective Date

The provision is effective for weeks beginning on or after the date of enactment.

**F. Revocation of Election Relating to Treatment as Multiemployer Plan
(sec. 3(37) of ERISA and sec. 414(f) of the Code)**

Present Law

A multiemployer plan means a plan (1) to which more than one employer is required to contribute; (2) which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer; and (3) which satisfies such other requirements as the Secretary of Labor may prescribe.²⁸¹ Present law provides that within one year after the date of enactment of the Multiemployer Pension Plan Amendments Act of 1980, a multiemployer plan could irrevocably elect for the plan not to be treated as a multiemployer plan if certain requirements were satisfied.

Explanation of Provision

The provision allows multiemployer plans to revoke an existing election not to treat the plan as a multiemployer plan if, for each of the three plan years prior to the date of enactment, the plan would have been a multiemployer plan, but for the extension in place. The revocation must be pursuant to procedures prescribed by the PBGC.

The provision also provides that a plan to which more than one employer is required to contribute which is maintained pursuant to one or more collective bargaining agreements between one or more employee organizations and more than one employer (collectively the "criteria") may, pursuant to procedures prescribed by the PBGC, elect to be a multiemployer plan if (1) for each of the three plan years prior to the date of enactment, the plan has met the criteria; (2) substantially all of the plan's employer contributions for each of those plan years were made or required to be made by organizations that were tax-exempt; and (3) the plan was established prior to September 2, 1974. Such election is also available in the case of a plan sponsored by an organization that was established in Chicago, Illinois, on August 12, 1881, and is described in Code section 501(c)(5). There is no inference that a plan that makes an election to be a multiemployer plan was not a multiemployer plan prior to the date of enactment or would not be a multiemployer plan without regard to the election.

An election made under the provision is effective beginning with the first plan year ending after date of enactment and is irrevocable. A plan that elects to be a multiemployer plan under the provision will cease to be a multiemployer plan as of the plan year beginning immediately after the first plan year for which the majority of its employer contributions were made or required to be made by organizations that were not tax-exempt. Elections and revocations under the provision must be made within one year after the date of enactment.

Not later than 30 days before an election is made, the plan administrator must provide notice of the pending election to each plan participant and beneficiary, each labor organization representing such participants or beneficiaries, and to each employer that has an obligation to

²⁸¹ ERISA sec. 3(36); Code sec. 414(f).

contribute to the plan. Such notice must include the principal differences between the guarantee programs and benefit restrictions for single employer and multiemployer plans. The Secretary of Labor must prescribe a model notice within 180 days after date of enactment. The plan administrator's failure to provide the notice is treated as a failure to file an annual report. Thus, an ERISA penalty of \$1,100 per day applies.

Effective Date

The provision is effective on the date of enactment.

G. Provisions Relating to Plan Amendments

Present Law

Present law provides a remedial amendment period during which, under certain circumstances, a plan may be amended retroactively in order to comply with the qualification requirements.²⁸² In general, plan amendments to reflect changes in 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. The Secretary of the Treasury may extend the time by which plan amendments need to be made.

The Code and ERISA provide that, in general, accrued benefits cannot be reduced by a plan amendment.²⁸³ This prohibition on the reduction of accrued benefits is commonly referred to as the "anticutback rule."

Explanation of Provision.

A plan amendment made pursuant to the changes made by the bill or regulations issued thereunder, may be retroactively effective and will not violate the anticutback rule, if, in addition to meeting the other applicable requirements, the amendment is made on or before the last day of the first plan year beginning on or after January 1, 2009 (2011 in the case of a governmental plan).

A plan amendment will not be considered to be pursuant to the bill (or applicable regulations) if it has an effective date before the effective date of the provision under the bill (or regulations) to which it relates. Similarly, the provision does not provide relief from the anticutback rule for periods prior to the effective date of the relevant provision (or regulations) or the plan amendment. The Secretary of the Treasury is authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It is intended that the Secretary will not permit inappropriate reductions in contributions or benefits that are not directly related to the provisions under the bill.

Effective Date

The provision is effective on the date of enactment.

²⁸² Sec. 401(b).

²⁸³ Code sec. 411(d)(6); ERISA sec. 204(g).

TITLE XII: PROVISIONS RELATING TO EXEMPT ORGANIZATIONS

A. Charitable Giving Incentives

1. Tax-free distributions from individual retirement plans for charitable purposes (secs. 408, 6034, 6104, and 6652 of the Code)

Present Law

In general

If an amount withdrawn from a traditional individual retirement arrangement (“IRA”) or a Roth IRA is donated to a charitable organization, the rules relating to the tax treatment of withdrawals from IRAs apply to the amount withdrawn and the charitable contribution is subject to the normally applicable limitations on deductibility of such contributions.

Charitable contributions

In computing taxable income, an individual taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and up to the fair market value of property contributed to a charity described in section 501(c)(3), to certain veterans’ organizations, fraternal societies, and cemetery companies,²⁸⁴ or to a Federal, State, or local governmental entity for exclusively public purposes.²⁸⁵ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.²⁸⁶

A taxpayer who takes the standard deduction (i.e., who does not itemize deductions) may not take a separate deduction for charitable contributions.²⁸⁷

A payment to a charity (regardless of whether it is termed a “contribution”) in exchange for which the donor receives an economic benefit is not deductible, except to the extent that the donor can demonstrate, among other things, that the payment exceeds the fair market value of the benefit received from the charity. To facilitate distinguishing charitable contributions from purchases of goods or services from charities, present law provides that no charitable contribution deduction is allowed for a separate contribution of \$250 or more unless the donor obtains a contemporaneous written acknowledgement of the contribution from the charity

²⁸⁴ Secs. 170(c)(3)-(5).

²⁸⁵ Sec. 170(c)(1).

²⁸⁶ Secs. 170(b) and (e).

²⁸⁷ Sec. 170(a).

indicating whether the charity provided any good or service (and an estimate of the value of any such good or service) to the taxpayer in consideration for the contribution.²⁸⁸ In addition, present law requires that any charity that receives a contribution exceeding \$75 made partly as a gift and partly as consideration for goods or services furnished by the charity (a “quid pro quo” contribution) is required to inform the contributor in writing of an estimate of the value of the goods or services furnished by the charity and that only the portion exceeding the value of the goods or services may be deductible as a charitable contribution.²⁸⁹

Under present law, total deductible contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer’s contribution base, which is the taxpayer’s adjusted gross income for a taxable year (disregarding any net operating loss carryback). To the extent a taxpayer has not exceeded the 50-percent limitation, (1) contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer’s contribution base, (2) contributions of cash to private foundations and certain other charitable organizations generally may be deducted up to 30 percent of the taxpayer’s contribution base, and (3) contributions of capital gain property to private foundations and certain other charitable organizations generally may be deducted up to 20 percent of the taxpayer’s contribution base.

Contributions by individuals in excess of the 50-percent, 30-percent, and 20-percent limits may be carried over and deducted over the next five taxable years, subject to the relevant percentage limitations on the deduction in each of those years.

In addition to the percentage limitations imposed specifically on charitable contributions, present law imposes a reduction on most itemized deductions, including charitable contribution deductions, for taxpayers with adjusted gross income in excess of a threshold amount, which is indexed annually for inflation. The threshold amount for 2006 is \$150,500 (\$75,250 for married individuals filing separate returns). For those deductions that are subject to the limit, the total amount of itemized deductions is reduced by three percent of adjusted gross income over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. Beginning in 2006, the overall limitation on itemized deductions phases-out for all taxpayers. The overall limitation on itemized deductions is reduced by one-third in taxable years beginning in 2006 and 2007, and by two-thirds in taxable years beginning in 2008 and 2009. The overall limitation on itemized deductions is eliminated for taxable years beginning after December 31, 2009; however, this elimination of the limitation sunsets on December 31, 2010.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity (e.g., a remainder) while also either retaining an interest in that property (e.g., an income interest) or transferring an interest in that property to a noncharity for less than full and adequate consideration.²⁹⁰ Exceptions to this

²⁸⁸ Sec. 170(f)(8).

²⁸⁹ Sec. 6115.

²⁹⁰ Secs. 170(f), 2055(e)(2), and 2522(c)(2).

general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, and present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property.²⁹¹ For such interests, a charitable deduction is allowed to the extent of the present value of the interest designated for a charitable organization.

IRA rules

Within limits, individuals may make deductible and nondeductible contributions to a traditional IRA. Amounts in a traditional IRA are includible in income when withdrawn (except to the extent the withdrawal represents a return of nondeductible contributions). Individuals also may make nondeductible contributions to a Roth IRA. Qualified withdrawals from a Roth IRA are excludable from gross income. Withdrawals from a Roth IRA that are not qualified withdrawals are includible in gross income to the extent attributable to earnings. Includible amounts withdrawn from a traditional IRA or a Roth IRA before attainment of age 59-½ are subject to an additional 10-percent early withdrawal tax, unless an exception applies. Under present law, minimum distributions are required to be made from tax-favored retirement arrangements, including IRAs. Minimum required distributions from a traditional IRA must generally begin by the April 1 of the calendar year following the year in which the IRA owner attains age 70-½.²⁹²

If an individual has made nondeductible contributions to a traditional IRA, a portion of each distribution from an IRA is nontaxable until the total amount of nondeductible contributions has been received. In general, the amount of a distribution that is nontaxable is determined by multiplying the amount of the distribution by the ratio of the remaining nondeductible contributions to the account balance. In making the calculation, all traditional IRAs of an individual are treated as a single IRA, all distributions during any taxable year are treated as a single distribution, and the value of the contract, income on the contract, and investment in the contract are computed as of the close of the calendar year.

In the case of a distribution from a Roth IRA that is not a qualified distribution, in determining the portion of the distribution attributable to earnings, contributions and distributions are deemed to be distributed in the following order: (1) regular Roth IRA contributions; (2) taxable conversion contributions;²⁹³ (3) nontaxable conversion contributions; and (4) earnings. In determining the amount of taxable distributions from a Roth IRA, all Roth IRA distributions in the same taxable year are treated as a single distribution, all regular Roth IRA contributions for a year are treated as a single contribution, and all conversion contributions during the year are treated as a single contribution.

²⁹¹ Sec. 170(f)(2).

²⁹² Minimum distribution rules also apply in the case of distributions after the death of a traditional or Roth IRA owner.

²⁹³ Conversion contributions refer to conversions of amounts in a traditional IRA to a Roth IRA.

Distributions from an IRA (other than a Roth IRA) are generally subject to withholding unless the individual elects not to have withholding apply.²⁹⁴ Elections not to have withholding apply are to be made in the time and manner prescribed by the Secretary.

Split-interest trust filing requirements

Split-interest trusts, including charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, are required to file an annual information return (Form 1041A).²⁹⁵ Trusts that are not split-interest trusts but that claim a charitable deduction for amounts permanently set aside for a charitable purpose²⁹⁶ also are required to file Form 1041A. The returns are required to be made publicly available.²⁹⁷ A trust that is required to distribute all trust net income currently to trust beneficiaries in a taxable year is exempt from this return requirement for such taxable year. A failure to file the required return may result in a penalty on the trust of \$10 a day for as long as the failure continues, up to a maximum of \$5,000 per return.

In addition, split-interest trusts are required to file annually Form 5227.²⁹⁸ Form 5227 requires disclosure of information regarding a trust's noncharitable beneficiaries. The penalty for failure to file this return is calculated based on the amount of tax owed. A split-interest trust generally is not subject to tax and therefore, in general, a penalty may not be imposed for the failure to file Form 5227. Form 5227 is not required to be made publicly available.

Explanation of Provision

Qualified charitable distributions from IRAs

The provision provides an exclusion from gross income for otherwise taxable IRA distributions from a traditional or a Roth IRA in the case of qualified charitable distributions.²⁹⁹ The exclusion may not exceed \$100,000 per taxpayer per taxable year. Special rules apply in determining the amount of an IRA distribution that is otherwise taxable. The present-law rules regarding taxation of IRA distributions and the deduction of charitable contributions continue to apply to distributions from an IRA that are not qualified charitable distributions. Qualified charitable distributions are taken into account for purposes of the minimum distribution rules applicable to traditional IRAs to the same extent the distribution would have been taken into account under such rules had the distribution not been directly distributed under the provision.

²⁹⁴ Sec. 3405.

²⁹⁵ Sec. 6034. This requirement applies to all split-interest trusts described in section 4947(a)(2).

²⁹⁶ Sec. 642(c).

²⁹⁷ Sec. 6104(b).

²⁹⁸ Sec. 6011; Treas. Reg. sec. 53.6011-1(d).

²⁹⁹ The provision does not apply to distributions from employer-sponsored retirements plans, including SIMPLE IRAs and simplified employee pensions ("SEPs").

An IRA does not fail to qualify as an IRA merely because qualified charitable distributions have been made from the IRA. It is intended that the Secretary will prescribe rules under which IRA owners are deemed to elect out of withholding if they designate that a distribution is intended to be a qualified charitable distribution.

A qualified charitable distribution is any distribution from an IRA directly by the IRA trustee to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund (as defined in section 4966(d)(2))). Distributions are eligible for the exclusion only if made on or after the date the IRA owner attains age 70-½.

The exclusion applies only if a charitable contribution deduction for the entire distribution otherwise would be allowable (under present law), determined without regard to the generally applicable percentage limitations. Thus, for example, if the deductible amount is reduced because of a benefit received in exchange, or if a deduction is not allowable because the donor did not obtain sufficient substantiation, the exclusion is not available with respect to any part of the IRA distribution.

If the IRA owner has any IRA that includes nondeductible contributions, a special rule applies in determining the portion of a distribution that is includible in gross income (but for the provision) and thus is eligible for qualified charitable distribution treatment. Under the special rule, the distribution is treated as consisting of income first, up to the aggregate amount that would be includible in gross income (but for the provision) if the aggregate balance of all IRAs having the same owner were distributed during the same year. In determining the amount of subsequent IRA distributions includible in income, proper adjustments are to be made to reflect the amount treated as a qualified charitable distribution under the special rule.

Distributions that are excluded from gross income by reason of the provision are not taken into account in determining the deduction for charitable contributions under section 170.

Qualified charitable distribution examples

The following examples illustrate the determination of the portion of an IRA distribution that is a qualified charitable distribution. In each example, it is assumed that the requirements for qualified charitable distribution treatment are otherwise met (e.g., the applicable age requirement and the requirement that contributions are otherwise deductible) and that no other IRA distributions occur during the year.

Example 1.—Individual A has a traditional IRA with a balance of \$100,000, consisting solely of deductible contributions and earnings. Individual A has no other IRA. The entire IRA balance is distributed in a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund). Under present law, the entire distribution of \$100,000 would be includible in Individual A's income. Accordingly, under the provision, the entire distribution of \$100,000 is a qualified charitable distribution. As a result, no amount is included in Individual A's income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual A's charitable deduction for the year.

Example 2.—Individual B has a traditional IRA with a balance of \$100,000, consisting of \$20,000 of nondeductible contributions and \$80,000 of deductible contributions and earnings. Individual B has no other IRA. In a distribution to an organization described in section 170(b)(1)(A) (other than an organization described in section 509(a)(3) or a donor advised fund), \$80,000 is distributed from the IRA. Under present law, a portion of the distribution from the IRA would be treated as a nontaxable return of nondeductible contributions. The nontaxable portion of the distribution would be \$16,000, determined by multiplying the amount of the distribution (\$80,000) by the ratio of the nondeductible contributions to the account balance (\$20,000/\$100,000). Accordingly, under present law, \$64,000 of the distribution (\$80,000 minus \$16,000) would be includible in Individual B’s income.

Under the provision, notwithstanding the present-law tax treatment of IRA distributions, the distribution is treated as consisting of income first, up to the total amount that would be includible in gross income (but for the provision) if all amounts were distributed from all IRAs otherwise taken into account in determining the amount of IRA distributions. The total amount that would be includible in income if all amounts were distributed from the IRA is \$80,000. Accordingly, under the provision, the entire \$80,000 distributed to the charitable organization is treated as includible in income (before application of the provision) and is a qualified charitable distribution. As a result, no amount is included in Individual B’s income as a result of the distribution and the distribution is not taken into account in determining the amount of Individual B’s charitable deduction for the year. In addition, for purposes of determining the tax treatment of other distributions from the IRA, \$20,000 of the amount remaining in the IRA is treated as Individual B’s nondeductible contributions (i.e., not subject to tax upon distribution).

Split-interest trust filing requirements

The provision increases the penalty on split-interest trusts for failure to file a return and for failure to include any of the information required to be shown on such return and to show the correct information. The penalty is \$20 for each day the failure continues up to \$10,000 for any one return. In the case of a split-interest trust with gross income in excess of \$250,000, the penalty is \$100 for each day the failure continues up to a maximum of \$50,000. In addition, if a person (meaning any officer, director, trustee, employee, or other individual who is under a duty to file the return or include required information)³⁰⁰ knowingly failed to file the return or include required information, then that person is personally liable for such a penalty, which would be imposed in addition to the penalty that is paid by the organization. Information regarding beneficiaries that are not charitable organizations as described in section 170(c) is exempt from the requirement to make information publicly available. In addition, the provision repeals the present-law exception to the filing requirement for split-interest trusts that are required in a taxable year to distribute all net income currently to beneficiaries. Such exception remains available to trusts other than split-interest trusts that are otherwise subject to the filing requirement.

³⁰⁰ Sec. 6652(c)(4)(C).

Effective Date

The provision relating to qualified charitable distributions is effective for distributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008. The provision relating to information returns of split-interest trusts is effective for returns for taxable years beginning after December 31, 2006.

2. Charitable deduction for contributions of food inventory (sec. 170 of the Code)

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis. The valuation of food inventory has been the subject of disputes between taxpayers and the IRS.³⁰¹

³⁰¹ *Lucky Stores Inc. v. Commissioner*, 105 T.C. 420 (1995) (holding that the value of surplus bread inventory donated to charity was the full retail price of the bread rather than half the retail price, as the IRS asserted).

Under the Katrina Emergency Tax Relief Act of 2005, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for certain donations made after August 28, 2005, and before January 1, 2006, of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other entity that is not a C corporation) from which contributions of "apparently wholesome food" are made. "Apparently wholesome food" is defined as food intended for human consumption that meets all quality and labeling standards imposed by Federal, State, and local laws and regulations even though the food may not be readily marketable due to appearance, age, freshness, grade, size, surplus, or other conditions.

Explanation of Provision

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, under the provision, any taxpayer, whether or not a C corporation, engaged in a trade or business is eligible to claim the enhanced deduction for donations of food inventory. For taxpayers other than C corporations, the total deduction for donations of food inventory in a taxable year generally may not exceed 10 percent of the taxpayer's net income for such taxable year from all sole proprietorships, S corporations, or partnerships (or other non C corporation) from which contributions of apparently wholesome food are made. For example, as under the Katrina Emergency Tax Relief Act of 2005, if a taxpayer is a sole proprietor, a shareholder in an S corporation, and a partner in a partnership, and each business makes charitable contributions of food inventory, the taxpayer's deduction for donations of food inventory is limited to 10 percent of the taxpayer's net income from the sole proprietorship and the taxpayer's interests in the S corporation and partnership. However, if only the sole proprietorship and the S corporation made charitable contributions of food inventory, the taxpayer's deduction would be limited to 10 percent of the net income from the trade or business of the sole proprietorship and the taxpayer's interest in the S corporation, but not the taxpayer's interest in the partnership.³⁰²

Under the provision, the enhanced deduction for food is available only for food that qualifies as "apparently wholesome food." "Apparently wholesome food" is defined as it is defined under the Katrina Emergency Tax Relief Act of 2005.

³⁰² The 10 percent limitation does not affect the application of the generally applicable percentage limitations. For example, if 10 percent of a sole proprietor's net income from the proprietor's trade or business was greater than 50 percent of the proprietor's contribution base, the available deduction for the taxable year (with respect to contributions to public charities) would be 50 percent of the proprietor's contribution base. Consistent with present law, such contributions may be carried forward because they exceed the 50 percent limitation. Contributions of food inventory by a taxpayer that is not a C corporation that exceed the 10 percent limitation but not the 50 percent limitation could not be carried forward.

Effective Date

The provision is effective for contributions made after December 31, 2005, and before January 1, 2008.

3. Basis adjustment to stock of S corporation contributing property (sec. 1367 of the Code)

Present Law

Under present law, if an S corporation contributes money or other property to a charity, each shareholder takes into account the shareholder's pro rata share of the contribution in determining its own income tax liability.³⁰³ A shareholder of an S corporation reduces the basis in the stock of the S corporation by the amount of the charitable contribution that flows through to the shareholder.³⁰⁴

Explanation of Provision

The provision provides that the amount of a shareholder's basis reduction in the stock of an S corporation by reason of a charitable contribution made by the corporation will be equal to the shareholder's pro rata share of the adjusted basis of the contributed property.³⁰⁵

Thus, for example, assume an S corporation with one individual shareholder makes a charitable contribution of stock with a basis of \$200 and a fair market value of \$500. The shareholder will be treated as having made a \$500 charitable contribution (or a lesser amount if the special rules of section 170(e) apply), and will reduce the basis of the S corporation stock by \$200.³⁰⁶

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2005, and taxable years beginning before January 1, 2008.

³⁰³ Sec. 1366(a)(1)(A).

³⁰⁴ Sec. 1367(a)(2)(B).

³⁰⁵ See Rev. Rul. 96-11 (1996-1 C.B. 140) for a rule reaching a similar result in the case of charitable contributions made by a partnership.

³⁰⁶ This example assumes that basis of the S corporation stock (before reduction) is at least \$200.

4. Charitable deduction for contributions of book inventory (sec. 170 of the Code)

Present Law

Under present law, a taxpayer's deduction for charitable contributions of inventory generally is limited to the taxpayer's basis (typically, cost) in the inventory, or if less the fair market value of the inventory.

For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis (sec. 170(e)(3)). In general, a C corporation's charitable contribution deductions for a year may not exceed 10 percent of the corporation's taxable income (sec. 170(b)(2)). To be eligible for the enhanced deduction, the contributed property generally must be inventory of the taxpayer, contributed to a charitable organization described in section 501(c)(3) (except for private nonoperating foundations), and the donee must (1) use the property consistent with the donee's exempt purpose solely for the care of the ill, the needy, or infants, (2) not transfer the property in exchange for money, other property, or services, and (3) provide the taxpayer a written statement that the donee's use of the property will be consistent with such requirements. In the case of contributed property subject to the Federal Food, Drug, and Cosmetic Act, the property must satisfy the applicable requirements of such Act on the date of transfer and for 180 days prior to the transfer.

A donor making a charitable contribution of inventory must make a corresponding adjustment to the cost of goods sold by decreasing the cost of goods sold by the lesser of the fair market value of the property or the donor's basis with respect to the inventory (Treas. Reg. sec. 1.170A-4A(c)(3)). Accordingly, if the allowable charitable deduction for inventory is the fair market value of the inventory, the donor reduces its cost of goods sold by such value, with the result that the difference between the fair market value and the donor's basis may still be recovered by the donor other than as a charitable contribution.

To use the enhanced deduction, the taxpayer must establish that the fair market value of the donated item exceeds basis.

The Katrina Emergency Tax Relief Act of 2005 extended the present-law enhanced deduction for C corporations to certain qualified book contributions made after August 28, 2005, and before January 1, 2006. For such purposes, a qualified book contribution means a charitable contribution of books to a public school that provides elementary education or secondary education (kindergarten through grade 12) and that is an educational organization that normally maintains a regular faculty and curriculum and normally has a regularly enrolled body of pupils or students in attendance at the place where its educational activities are regularly carried on. The enhanced deduction under the Katrina Emergency Tax Relief Act of 2005 is not allowed unless the donee organization certifies in writing that the contributed books are suitable, in terms of currency, content, and quantity, for use in the donee's educational programs and that the donee will use the books in such educational programs.

Explanation of Provision

The provision extends the provision enacted as part of the Katrina Emergency Tax Relief Act of 2005. As under such Act, an enhanced deduction for C corporations for qualified book contributions is allowed.

Effective Date

The provision is effective for contributions made after December 31, 2005, and before January 1, 2008.

5. Modify tax treatment of certain payments to controlling exempt organizations (secs. 512 and 6033 of the Code)

Present Law

In general, interest, rents, royalties, and annuities are excluded from the unrelated business income of tax-exempt organizations. However, section 512(b)(13) generally treats otherwise excluded rent, royalty, annuity, and interest income as unrelated business income if such income is received from a taxable or tax-exempt subsidiary that is 50 percent controlled by the parent tax-exempt organization. In the case of a stock subsidiary, “control” means ownership by vote or value of more than 50 percent of the stock. In the case of a partnership or other entity, control means ownership of more than 50 percent of the profits, capital or beneficial interests. In addition, present law applies the constructive ownership rules of section 318 for purposes of section 512(b)(13). Thus, a parent exempt organization is deemed to control any subsidiary in which it holds more than 50 percent of the voting power or value, directly (as in the case of a first-tier subsidiary) or indirectly (as in the case of a second-tier subsidiary).

Under present law, interest, rent, annuity, or royalty payments made by a controlled entity to a tax-exempt organization are includable in the latter organization’s unrelated business income and are subject to the unrelated business income tax to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt).

Explanation of Provision

The provision provides that the general rule of section 512(b)(13), which includes interest, rent, annuity, or royalty payments made by a controlled entity to the controlling tax-exempt organization in the latter organization’s unrelated business income to the extent the payment reduces the net unrelated income (or increases any net unrelated loss) of the controlled entity, applies only to the portion of payments received or accrued in a taxable year that exceeds the amount of the specified payment that would have been paid or accrued if such payment had been determined under the principles of section 482. Thus, if a payment of rent by a controlled subsidiary to its tax-exempt parent organization exceeds fair market value, the excess amount of such payment over fair market value (as determined in accordance with section 482) is included in the parent organization’s unrelated business income, to the extent that such excess reduced the net unrelated income (or increased any net unrelated loss) of the controlled entity (determined as if the entity were tax exempt). In addition, the provision imposes a 20-percent penalty on the

larger of such excess determined without regard to any amendment or supplement to a return of tax, or such excess determined with regard to all such amendments and supplements. The provision applies only to payments made pursuant to a binding written contract in effect on the date of enactment (or renewal of such a contract on substantially similar terms). It is intended that there should be further study of such arrangements in light of the provision before any determination about whether to extend or expand the provision is made.

The provision requires that a tax-exempt organization that receives interest, rent, annuity, or royalty payments from a controlled entity report such payments on its annual information return as well as any loans made to any controlled entity and any transfers between such organization and a controlled entity.

The provision provides that, not later than January 1, 2009, the Secretary shall submit a report to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives a report on the effectiveness of the Internal Revenue Service in administering the provision and on the extent to which payments by controlled entities to the controlling exempt organization meet the requirements of section 482 of the Code. Such report shall include the results of any audit of any controlling organization or controlled entity and recommendations relating to the tax treatment of payments from controlled entities to controlling organizations.

Effective Date

The provision related to payments to controlling organizations applies to payments received or accrued after December 31, 2005 and before January 1, 2008. The provision relating to reporting is effective for returns the due date (determined without regard to extensions) of which is after the date of enactment. The provision relating to a report is effective on the date of enactment.

6. Encourage contributions of real property made for conservation purposes (sec. 170 of the Code)

Present Law

Charitable contributions generally

In general, a deduction is permitted for charitable contributions, subject to certain limitations that depend on the type of taxpayer, the property contributed, and the donee organization. The amount of deduction generally equals the fair market value of the contributed property on the date of the contribution. Charitable deductions are provided for income, estate, and gift tax purposes.³⁰⁷

In general, in any taxable year, charitable contributions by a corporation are not deductible to the extent the aggregate contributions exceed 10 percent of the corporation's

³⁰⁷ Secs. 170, 2055, and 2522, respectively.

taxable income computed without regard to net operating or capital loss carrybacks. For individuals, the amount deductible is a percentage of the taxpayer's contribution base, which is the taxpayer's adjusted gross income computed without regard to any net operating loss carryback. The applicable percentage of the contribution base varies depending on the type of donee organization and property contributed. Cash contributions of an individual taxpayer to public charities, private operating foundations, and certain types of private nonoperating foundations may not exceed 50 percent of the taxpayer's contribution base. Cash contributions to private foundations and certain other organizations generally may be deducted up to 30 percent of the taxpayer's contribution base.

In general, a charitable deduction is not allowed for income, estate, or gift tax purposes if the donor transfers an interest in property to a charity while also either retaining an interest in that property or transferring an interest in that property to a noncharity for less than full and adequate consideration. Exceptions to this general rule are provided for, among other interests, remainder interests in charitable remainder annuity trusts, charitable remainder unitrusts, and pooled income funds, present interests in the form of a guaranteed annuity or a fixed percentage of the annual value of the property, and qualified conservation contributions.

Capital gain property

Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property to a qualified charity are deductible at fair market value within certain limitations. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(A) (e.g., public charities, private foundations other than private non-operating foundations, and certain governmental units) generally are deductible up to 30 percent of the taxpayer's contribution base. An individual may elect, however, to bring all these contributions of capital gain property for a taxable year within the 50-percent limitation category by reducing the amount of the contribution deduction by the amount of the appreciation in the capital gain property. Contributions of capital gain property to charitable organizations described in section 170(b)(1)(B) (e.g., private non-operating foundations) are deductible up to 20 percent of the taxpayer's contribution base.

For purposes of determining whether a taxpayer's aggregate charitable contributions in a taxable year exceed the applicable percentage limitation, contributions of capital gain property are taken into account after other charitable contributions. Contributions of capital gain property that exceed the percentage limitation may be carried forward for five years.

Qualified conservation contributions

Qualified conservation contributions are not subject to the "partial interest" rule, which generally bars deductions for charitable contributions of partial interests in property. A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made of the real

property. Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations. Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.

Qualified conservation contributions of capital gain property are subject to the same limitations and carryover rules of other charitable contributions of capital gain property.

Explanation of Provision

In general

Under the provision, the 30-percent contribution base limitation on contributions of capital gain property by individuals does not apply to qualified conservation contributions (as defined under present law). Instead, individuals may deduct the fair market value of any qualified conservation contribution to an organization described in section 170(b)(1)(A) to the extent of the excess of 50 percent of the contribution base over the amount of all other allowable charitable contributions. These contributions are not taken into account in determining the amount of other allowable charitable contributions.

Individuals are allowed to carryover any qualified conservation contributions that exceed the 50-percent limitation for up to 15 years.

For example, assume an individual with a contribution base of \$100 makes a qualified conservation contribution of property with a fair market value of \$80 and makes other charitable contributions subject to the 50-percent limitation of \$60. The individual is allowed a deduction of \$50 in the current taxable year for the non-conservation contributions (50 percent of the \$100 contribution base) and is allowed to carryover the excess \$10 for up to 5 years. No current deduction is allowed for the qualified conservation contribution, but the entire \$80 qualified conservation contribution may be carried forward for up to 15 years.

Farmers and ranchers

Individuals

In the case of an individual who is a qualified farmer or rancher for the taxable year in which the contribution is made, a qualified conservation contribution is allowable up to 100 percent of the excess of the taxpayer's contribution base over the amount of all other allowable charitable contributions.

In the above example, if the individual is a qualified farmer or rancher, in addition to the \$50 deduction for non-conservation contributions, an additional \$50 for the qualified

conservation contribution is allowed and \$30 may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

Corporations

In the case of a corporation (other than a publicly traded corporation) that is a qualified farmer or rancher for the taxable year in which the contribution is made, any qualified conservation contribution is allowable up to 100 percent of the excess of the corporation's taxable income (as computed under section 170(b)(2)) over the amount of all other allowable charitable contributions. Any excess may be carried forward for up to 15 years as a contribution subject to the 100-percent limitation.

Requirement that land be available for agriculture or livestock production

As an additional condition of eligibility for the 100 percent limitation, with respect to any contribution of property in agriculture or livestock production, or that is available for such production, by a qualified farmer or rancher, the qualified real property interest must include a restriction that the property remain generally available for such production. (There is no requirement as to any specific use in agriculture or farming, or necessarily that the property be used for such purposes, merely that the property remain available for such purposes.) Such additional condition does not apply to contributions made after December 31, 2005, and on or before the date of enactment.

Definition

A qualified farmer or rancher means a taxpayer whose gross income from the trade of business of farming (within the meaning of section 2032A(e)(5)) is greater than 50 percent of the taxpayer's gross income for the taxable year.

Effective Date

The provision applies to contributions made in taxable years beginning after December 31, 2005, and before January 1, 2008.

7. Excise tax exemptions for blood collector organizations (secs. 4041, 4221, 4253, 4483, 6416, and 7701 of the Code)

Present Law

American National Red Cross

The American National Red Cross ("Red Cross") is a Congressionally chartered corporation. It is responsible for giving aid to members of the U.S. Armed Forces, to disaster victims in the United States and abroad to help people prevent, prepare for, and respond to

emergencies.³⁰⁸ The Red Cross is responsible for over half of the nation's blood supply and blood products.

Exemption from certain retail and manufacturers excise taxes

The Code permits the Secretary to exempt from excise tax certain articles and services to be purchased for the exclusive use of the United States (sec. 4293). This authority is conditioned upon the Secretary determining (1) that the imposition of such taxes will cause substantial burden or expense which can be avoided by granting tax exemption and (2) that full benefit of such exemption, if granted, will accrue to the United States.

On April 18, 1979, the Secretary exercised this authority to exempt, with limited exceptions, the Red Cross from the taxes imposed by chapters 31 and 32 of the Code with respect to articles sold to the Red Cross for its exclusive use.³⁰⁹ An exemption is also authorized from the taxes imposed with respect to tires and inner tubes if such tire or inner tube is sold by any person on or in connection with the sale of any article to the American National Red Cross, for its exclusive use.³¹⁰ No exemption is provided from the gas guzzler tax (sec. 4064), and the taxes imposed on aviation fuel, on fuel used on inland waterways (sec. 4042), and on coal (sec. 4121).³¹¹ The exemption is subject to registration requirements for tax-free sales contained in Treasury regulations. Credit and refund of tax is subject to the requirements set forth in section 6416 relating to the exemption for taxable articles sold for the exclusive use of State and local governments.

Exemption from heavy highway motor vehicle use tax

An annual use tax is imposed on highway motor vehicles, at the rates below (sec. 4481).

Under 55,000 pounds	No tax
55,000-75,000 pounds	\$100 plus \$22 per 1,000 pounds over 55,000
Over 75,000 pounds	\$550

³⁰⁸ See 36 U.S.C. sec. 300102.

³⁰⁹ Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes -Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979-1 C.B. 478 (1979). At the time the notice was issued the following taxes were covered in Chapters 31 and 32: special fuels, automotive and related items (motor vehicles, tires and tubes, petroleum products, coal, and recreational equipment (sporting goods and firearms).

³¹⁰ Under present law, there is no longer a tax on inner tubes.

³¹¹ Department of the Treasury, *Notice-Manufacturers and Retailers Excise Taxes -Exemption from Tax of Sales of Certain Articles to the American Red Cross*, 44 F.R. 23407, 1979-1 C.B. 478, at 479 (1979). The Treasury notice also exempts the Red Cross from tax on aircraft tires and tubes, however, present law currently limits the tax to highway vehicle tires (sec. 4071(a)).

The Code provides that the Secretary may authorize exemption from the heavy highway vehicle use tax as to the use by the United States of any particular highway motor vehicle or class of highway motor vehicles if the Secretary determines that the imposition of such tax with respect to such use will cause substantial burden or expense which can be avoided by granting tax exemption and that the full benefit of such exemption, if granted will accrue to the United States (sec. 4483(b)). The IRS has ruled that the Red Cross comes within the term “United States” for purposes of the exemption from the heavy highway motor vehicle use tax (Rev. Rul. 76-510).

Exemption from communications excise tax

The Code imposes a three-percent tax on amounts paid for local telephone service; toll telephone service and teletypewriter exchange service (sec. 4251). These taxes do not apply to amounts paid for services furnished to the Red Cross (sec. 4253(c)).

Certain other tax-free sales

Exemption from certain manufacturer and retail sale excise taxes

The following sales generally are exempt from certain manufacturer and retail sale excise taxes: (1) for use by the purchaser for further manufacture, or for resale to a second purchaser in further manufacture; (2) for export or for resale to a second purchaser for export; (3) for use by the purchaser as supplies for vessels or aircraft; (4) to a State or local government for the exclusive use of a State or local government; and (5) to a nonprofit educational organization for its exclusive use (sec. 4221). The exemption generally applies to manufacturers taxes imposed by chapter 32 of the Code (the gas guzzlers tax, and the taxes imposed on tires, certain vaccines, and recreational equipment) and the tax on retail sales of heavy trucks and trailers.³¹²

The manufacturers excise taxes on coal (sec. 4121), on gasoline, diesel fuel, and kerosene (sec. 4081) are not covered by the exemption. The exemption for a sale to a State or local government for their exclusive use and the exemption for sales to a nonprofit educational organization does not apply to the gas guzzlers tax, and the tax on vaccines. In addition, the exemption of sales for use as supplies for vessels and aircraft does not apply to the vaccine tax.

Exempt sales of special fuels

A retail excise tax is imposed on special motor fuels, including propane, compressed natural gas, and certain alcohol mixtures (sec. 4041). Section 4041 also serves as a back-up tax for diesel fuel or kerosene that was not subject to the manufacturers taxes under section 4081 (other than the Leaking Underground Storage Tank Trust Fund tax) if such fuel is delivered into

³¹² The tax imposed by subchapter A of chapter 31 (relating to luxury passenger vehicles) are also exempt pursuant to this provision, however, this tax expired on December 31, 2002. (sec. 4001(g).)

the fuel supply tank of a diesel-powered highway vehicle or train.³¹³ No tax is imposed on these fuels for nontaxable uses, including fuel: (1) sold for use or used as supplies for vessels or aircraft, (2) sold for the exclusive use of any State, any political subdivision of a State, or the District of Columbia or used by such entity as fuel, (3) sold for export, or for shipment to a possession of the United States and is actually exported or shipped, (4) sold to a nonprofit educational organization for its exclusive use, or used by such entity as fuel (sec. 4041(g)).

Credits and refunds

In general

A credit or refund is allowed for overpayment of manufacturers or retail excise taxes (sec. 6416). Overpayments include (1) certain uses and resales, (2) price adjustments, and (3) further manufacture.

Specified uses and resales

The special fuel taxes, the retail tax on heavy trucks and trailers, and any of the manufacturers excise taxes paid on any article will be a deemed overpayment subject to credit or refund if sold for certain specified uses (sec. 6416(b)(2)). These uses are (1) export, (2) used or sold for use as supplies for vessels or aircraft, (3) sold to a State or local government for the exclusive use of a State or local government, (4) sold to a nonprofit educational organization for its exclusive use; (5) taxable tires sold to any person for use in connection with a qualified bus, or (6) the case of gasoline used or sold for use in the production of a special fuel. Certain exceptions apply in that this deemed overpayment rule does not apply to the taxes imposed by sections 4041 and 4081 on diesel fuel and kerosene, and the coal taxes (sec. 4121). Additionally, the deemed overpayment rule does not apply to the gas guzzler tax in the case of an article sold to a state or local government for its exclusive use or sold to an educational organization for its exclusive use.

Special rule for tires sold in connection with other articles

If the tax imposed on tires (sec. 4071) has been paid with respect to the sale of any tire by the manufacturer, producer, or importer, and such tire is sold by any person in connection with the sale of any other article, such tax will be deemed an overpayment by person if such other article (1) is an automobile bus chassis or an automobile bus body, or (2) is by any person exported, sold to a State or local government for exclusive use of a State or local government, sold to a nonprofit educational organization for its exclusive use, or used or sold for use as supplies for vessels or aircraft (sec. 6416(b)(4)).

Gasoline used for exempt purposes

³¹³ For example, tax is imposed on the delivery of any of the following into the fuel supply tank of a diesel powered highway vehicle or train of any dyed diesel or dyed kerosene for other than a nontaxable use; any undyed diesel fuel or undyed kerosene on which a credit or refund.

If gasoline is sold to any person for certain specified purposes, the Secretary is required to pay (without interest) to such person an amount equal to the product of the number of gallons of gasoline so sold multiplied by the rate at which tax was imposed on such gasoline under section 4081 (sec. 6421(c)). Under this provision, the specified purposes are (1) for export or for resale to a second purchaser for export; (2) for use by the purchaser as supplies for vessels or aircraft; (3) to a State or local government for exclusive use of a State or local government; and (4) to a nonprofit educational organization for its exclusive use (sec. 4221(a), 6421(c)).

Diesel fuel or kerosene used in a nontaxable use

If diesel fuel or kerosene, upon which tax has been imposed is used by any person in a nontaxable use, the Code authorizes the Secretary to pay (without interest) an amount equal to the aggregate amount of tax imposed on such fuel (sec. 6427(l)). Nontaxable uses include any exemption from the tax imposed by section 4041(a) (except prior taxation).

Explanation of Provision

The provision exempts qualified blood collector organizations from certain retail and manufacturers excise taxes to the extent such items are for the exclusive use of such an organization for the distribution or collection of blood. A qualified blood collector organization means an organization that is (1) described in section 501(c)(3) and exempt from tax under section 501(a), (2) primarily engaged in the activity of the collection of blood, (3) registered with the Secretary for purposes of excise tax exemptions, and (4) registered by the Food and Drug Administration to collect blood.

Under the provision, qualified blood collector organizations are exempt from the communications excise tax as provided by Treasury regulations. The provision also provides an exemption from the special fuels tax, and certain taxes imposed by chapter 32 and subchapter A and C of chapter 31 of the Code (i.e., the retail excise tax on heavy trucks and trailers, and the manufacturers excise taxes on tires).³¹⁴ The provision also makes conforming amendments to allow for the credit or refund of these taxes and any tax paid on gasoline for the exclusive use of the blood collector organization. The provision also permits a refund of tax for diesel fuel or kerosene used by a qualified blood collector organization. Finally, the provision provides an exemption from the heavy vehicle use tax of a “qualified blood collector vehicle” by a qualified blood collector organization. A “qualified blood collector vehicle” means a vehicle at least 80 percent of the use of which during the prior taxable period was by a qualified blood collector organization in the collection, storage, or transportation of blood. A special rule is provided for the first taxable period a vehicle is placed in service by the qualified blood collector organization. For the first taxable period a vehicle is placed in service by the organization, the vehicle will be treated as a “qualified blood collector vehicle” for that period if the organization certifies that it reasonably expects that at least 80 percent of the use of the vehicle during such

³¹⁴ Such organizations are also exempt from the expired retail excise tax on luxury passenger vehicles. No exemption is provided from the gas guzzler tax (sec. 4064), the taxes imposed on fuel used on inland waterways (sec. 4042), on coal (sec. 4121), and on recreational equipment (sport fishing equipment, bows, arrow components, and firearms).

taxable period will be by the organization in the collection, storage, or transportation of blood. Such certification is to be provided to the Secretary on such forms and in such manner as the Secretary may require.

It is expected that the excise tax exemptions of the Red Cross will be reexamined in conjunction with a review of its charter.

Effective Date

Generally, the provision is effective on January 1, 2007. The exemption from the heavy vehicle use tax is effective for taxable periods beginning July 1, 2007.

B. Reforming Exempt Organizations

1. Reporting on certain acquisitions of interests in insurance contracts in which certain exempt organizations hold interests (new sec. 6050V of the Code)

Present Law

Amounts received under a life insurance contract

Amounts received under a life insurance contract paid by reason of the death of the insured are not includible in gross income for Federal tax purposes.³¹⁵ No Federal income tax generally is imposed on a policyholder with respect to the earnings under a life insurance contract (inside buildup).³¹⁶

Distributions from a life insurance contract (other than a modified endowment contract) that are made prior to the death of the insured generally are includible in income to the extent that the amounts distributed exceed the taxpayer's investment in the contract (i.e., basis). Such distributions generally are treated first as a tax-free recovery of basis, and then as income.³¹⁷

Transfers for value

A limitation on the exclusion for amounts received under a life insurance contract is provided in the case of transfers for value. If a life insurance contract (or an interest in the contract) is transferred for valuable consideration, the amount excluded from income by reason of the death of the insured is limited to the actual value of the consideration plus the premiums and other amounts subsequently paid by the acquiror of the contract.³¹⁸

³¹⁵ Sec. 101(a).

³¹⁶ This favorable tax treatment is available only if a life insurance contract meets certain requirements designed to limit the investment character of the contract. Sec. 7702.

³¹⁷ Sec. 72(e). In the case of a modified endowment contract, however, in general, distributions are treated as income first, loans are treated as distributions (i.e., income rather than basis recovery first), and an additional 10-percent tax is imposed on the income portion of distributions made before age 59-½ and in certain other circumstances. Secs. 72(e) and (v). A modified endowment contract is a life insurance contract that does not meet a statutory "7-pay" test, i.e., generally is funded more rapidly than seven annual level premiums. Sec. 7702A.

³¹⁸ Section 101(a)(2). The transfer-for-value rule does not apply, however, in the case of a transfer in which the life insurance contract (or interest in the contract) transferred has a basis in the hands of the transferee that is determined by reference to the transferor's basis. Similarly, the transfer-for-value rule generally does not apply if the transfer is between certain parties (specifically, if the transfer is to the insured, a partner of the insured, a partnership in which the insured is a partner, or a corporation in which the insured is a shareholder or officer).

Tax treatment of charitable organizations and donors

Present law generally provides tax-exempt status for charitable, educational and certain other organizations, no part of the net earnings of which inures to the benefit of any private shareholder or individual, and which meet certain other requirements.³¹⁹ Governmental entities, including some educational organizations, are exempt from tax on income under other tax rules providing that gross income does not include income derived from the exercise of any essential governmental function and accruing to a State or any political subdivision thereof.³²⁰

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity for exclusively public purposes.³²¹

State-law insurable interest rules

State laws generally provide that the owner of a life insurance contract must have an insurable interest in the insured person when the life insurance contract is issued. State laws vary as to the insurable interest of a charitable organization in the life of any individual. Some State laws provide that a charitable organization meeting the requirements of section 501(c)(3) of the Code is treated as having an insurable interest in the life of any donor,³²² or, in other States, in the life of any individual who consents (whether or not the individual is a donor).³²³ Other States' insurable interest rules permit the purchase of a life insurance contract even though the person paying the consideration has no insurable interest in the life of the person insured if a charitable, benevolent, educational or religious institution is designated irrevocably as the beneficiary.³²⁴

Transactions involving charities and non-charities acquiring life insurance

Recently, there has been an increase in transactions involving the acquisition of life insurance contracts using arrangements in which both exempt organizations, primarily charities,

³¹⁹ Section 501(c)(3).

³²⁰ Section 115.

³²¹ Section 170.

³²² See, e.g., Mass. Gen. Laws Ann. ch. 175, sec. 123A(2) (West 2005); Iowa Code Ann. sec. 511.39 (West 2004) ("a person who, when purchasing a life insurance policy, makes a donation to the charitable organization or makes the charitable organization the beneficiary of all or a part of the proceeds of the policy . . .).

³²³ See, e.g., Cal. Ins. Code sec. 10110.1(f) (West 2005); 40 Pa. Cons. Stat. Ann. sec. 40-512 (2004); Fla. Stat. Ann. sec. 27.404 (2) (2004); Mich. Comp. Laws Ann. sec. 500.2212 (West 2004).

³²⁴ Or. Rev. Stat. sec. 743.030 (2003); Del. Code Ann. Tit. 18, sec. 2705(a) (2004).

and private investors have an interest in the contract.³²⁵ The exempt organization has an insurable interest in the insured individuals, either because they are donors, because they consent, or otherwise under applicable State insurable interest rules. Private investors provide capital used to fund the purchase of the life insurance contracts, sometimes together with annuity contracts. Both the private investors and the charity have an interest in the contracts, directly or indirectly, through the use of trusts, partnerships, or other arrangements for sharing the rights to the contracts. Both the charity and the private investors receive cash amounts in connection with the investment in the contracts while the life insurance is in force or as the insured individuals die.

Explanation of Provision

The provision includes a temporary reporting requirement with respect to the acquisition of interests in certain life insurance contracts by certain exempt organizations, together with a Treasury study.

The provision provides that, for reportable acquisitions occurring after the date of enactment and on or before the date two years from the date of enactment, an applicable exempt organization that makes a reportable acquisition is required to file an information return. The information return is to contain the name, address, and taxpayer identification number of the organization and of the issuer of the applicable insurance contract, and such other information as the Secretary of the Treasury prescribes. It is intended that the Treasury Department may require the reporting of other information relevant to the study required under the provision. The report is to be in the form prescribed by the Treasury Secretary and is required to be filed at the time established by the Treasury Secretary. It is intended that the Treasury Department may require the report to be filed within a certain period after the reportable acquisition takes place in order to gather information in a timely manner that is relevant to the study required under the provision.

For this purpose, a reportable acquisition means the acquisition by an applicable exempt organization of a direct or indirect interest in a contract that the applicable exempt organization knows or has reason to know is an applicable insurance contract, if such acquisition is a part of a structured transaction involving a pool of such contracts.

An applicable insurance contract means any life insurance, annuity, or endowment contract with respect to which both an applicable exempt organization and a person other than an applicable exempt organization have directly or indirectly held an interest in the contract (whether or not at the same time). Exceptions apply under this definition. First, the term does not apply if each person (other than an applicable exempt organization) with a direct or indirect interest in the contract has an insurable interest in the insured independent of any interest of the exempt organization in the contract. Second, the term does not apply if the sole interest in the contract of the applicable exempt organization or each person other than the applicable exempt

³²⁵ Davis, Wendy, "Death-Pool Donations," *Trusts and Estates*, May 2004, 55; Francis, Theo, "Tax May Thwart Investment Plans Enlisting Charities," *Wall St. J.*, Feb. 8, 2005, A-10.

organization is as a named beneficiary. Third, the term does not apply if the sole interest in the contract of each person other than the applicable exempt organization is either (1) as a beneficiary of a trust holding an interest in the contract, but only if the person's designation as such a beneficiary was made without consideration and solely on a purely gratuitous basis, or (2) as a trustee who holds an interest in the contract in a fiduciary capacity solely for the benefit of applicable exempt organizations or of persons otherwise meeting one of the first two exceptions.

An applicable exempt organization is any organization described in section 170(c), 168(h)(2)(A)(iv), 2055(a), or 2522(a). Thus, for example, an applicable exempt organization generally includes an organization that is exempt from Federal income tax by reason of being described in section 501(c)(3) (including one organized outside the United States), a government or political subdivision of a government, and an Indian tribal government.

Under the provision, penalties apply for failure to file the return.

The reporting requirement terminates with respect to reportable acquisitions occurring after the date that is 2 years after the date of enactment.

The provision requires the Treasury Secretary to undertake a study on the use by tax-exempt organizations of applicable insurance contracts for the purpose of sharing the benefits of the organization's insurable interest in insured individuals under such contracts with investors, and whether such activities are consistent with the tax-exempt status of the organizations. The study may, for example, address whether certain such arrangements are or may be used to improperly shelter income from tax, and whether they should be listed transactions within the meaning of Treasury Regulation section 1.6011-4(b)(2). No later than 30 months after the date of enactment, the Treasury Secretary is required to report on the study to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Effective Date

The reporting provision is effective for acquisitions of contracts after the date of enactment. The study provision is effective on the date of enactment.

2. Increase the amounts of excise taxes imposed relating to public charities, social welfare organizations, and private foundations (secs. 4941, 4942, 4943, 4944, 4945, and 4958 of the Code)

Present Law

Public charities and social welfare organizations

The Code imposes excise taxes on excess benefit transactions between disqualified persons (as defined in section 4958(f)) and charitable organizations (other than private

foundations) or social welfare organizations (as described in section 501(c)(4)).³²⁶ An excess benefit transaction generally is a transaction in which an economic benefit is provided by a charitable or social welfare organization directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

The excess benefit tax is imposed on the disqualified person and, in certain cases, on the organization manager, but is not imposed on the exempt organization. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.³²⁷ If more than one person is liable for the tax on disqualified persons or on management, all such persons are jointly and severally liable for the tax.³²⁸

Private foundations

Self-dealing by private foundations

Excise taxes are imposed on acts of self-dealing between a disqualified person (as defined in section 4946) and a private foundation.³²⁹ In general, self-dealing transactions are any direct or indirect: (1) sale or exchange, or leasing, of property between a private foundation and a disqualified person; (2) lending of money or other extension of credit between a private foundation and a disqualified person; (3) the furnishing of goods, services, or facilities between a private foundation and a disqualified person; (4) the payment of compensation (or payment or reimbursement of expenses) by a private foundation to a disqualified person; (5) the transfer to, or use by or for the benefit of, a disqualified person of the income or assets of the private foundation; and (6) certain payments of money or property to a government official.³³⁰ Certain exceptions apply.³³¹

³²⁶ Sec. 4958. The excess benefit transaction tax commonly is referred to as “intermediate sanctions,” because it imposes penalties generally considered to be less punitive than revocation of the organization’s exempt status.

³²⁷ Sec. 4958(d)(2). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

³²⁸ Sec. 4958(d)(1).

³²⁹ Sec. 4941.

³³⁰ Sec. 4941(d)(1).

³³¹ See sec. 4941(d)(2).

An initial tax of five percent of the amount involved with respect to an act of self-dealing is imposed on any disqualified person (other than a foundation manager acting only as such) who participates in the act of self-dealing. If such a tax is imposed, a 2.5-percent tax of the amount involved is imposed on a foundation manager who participated in the act of self-dealing knowing it was such an act (and such participation was not willful and was due to reasonable cause) up to \$10,000 per act. Such initial taxes may not be abated.³³² Such initial taxes are imposed for each year in the taxable period, which begins on the date the act of self-dealing occurs and ends on the earliest of the date of mailing of a notice of deficiency for the tax, the date on which the tax is assessed, or the date on which correction of the act of self-dealing is completed. A government official (as defined in section 4946(c)) is subject to such initial tax only if the official participates in the act of self-dealing knowing it is such an act. If the act of self-dealing is not corrected, a tax of 200 percent of the amount involved is imposed on the disqualified person and a tax of 50 percent of the amount involved (up to \$10,000 per act) is imposed on a foundation manager who refused to agree to correcting the act of self-dealing. Such additional taxes are subject to abatement.³³³

Tax on failure to distribute income

Private nonoperating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization's exempt purposes, including reasonable and necessary administrative expenses.³³⁴ Failure to pay out the minimum results in an initial excise tax on the foundation of 15 percent of the undistributed amount. An additional tax of 100 percent of the undistributed amount applies if an initial tax is imposed and the required distributions have not been made by the end of the applicable taxable period.³³⁵ A foundation may include as a qualifying distribution the salaries, occupancy expenses, travel costs, and other reasonable and necessary administrative expenses that the foundation incurs in operating a grant program. A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization's exempt purposes and certain amounts set-aside for exempt purposes.³³⁶ Private operating foundations are not subject to the payout requirements.

³³² Sec. 4962(b).

³³³ Sec. 4961.

³³⁴ Sec. 4942(g)(1)(A).

³³⁵ Sec. 4942(a) and (b). Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

³³⁶ Sec. 4942(g)(1)(B) and 4942(g)(2). In general, an organization is permitted to adjust the distributable amount in those cases where distributions during the five preceding years have exceeded the payout requirements. Sec. 4942(i).

Tax on excess business holdings

Private foundations are subject to tax on excess business holdings.³³⁷ In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership (“profits interest” is substituted for “voting stock” and “capital interest” for “nonvoting stock”) and to other unincorporated enterprises (by substituting “beneficial interest” for “voting stock”). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.³³⁸ This five-year period may be extended an additional five years in limited circumstances.³³⁹ The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.³⁴⁰

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation’s applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Tax on jeopardizing investments

Private foundations and foundation managers are subject to tax on investments that jeopardize the foundation’s charitable purpose.³⁴¹ In general, an initial tax of five percent of the amount of the investment applies to the foundation and to foundation managers who participated in the making of the investment knowing that it jeopardized the carrying out of the foundation’s exempt purposes. The initial tax on foundation managers may not exceed \$5,000 per investment. If the investment is not removed from jeopardy (e.g., sold or otherwise disposed of), an additional tax of 25 percent of the amount of the investment is imposed on the foundation and five percent of the amount of the investment on a foundation manager who refused to agree to removing the investment from jeopardy. The additional tax on foundation managers may not exceed \$10,000 per investment. An investment, the primary purpose of which is to accomplish a

³³⁷ Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

³³⁸ Sec. 4943(c)(6).

³³⁹ Sec. 4943(c)(7).

³⁴⁰ Sec. 4943(d)(3).

³⁴¹ Sec. 4944. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

charitable purpose and no significant purpose of which is the production of income or the appreciation of property, is not considered a jeopardizing investment.³⁴²

Tax on taxable expenditures

Certain expenditures of private foundations are subject to tax.³⁴³ In general, taxable expenditures are expenses: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility³⁴⁴ with respect to the grant; or (5) for any non-charitable purpose. For each taxable expenditure, a tax is imposed on the foundation of 10 percent of the amount of the expenditure, and an additional tax of 100 percent is imposed on the foundation if the expenditure is not corrected. A tax of 2.5 percent of the expenditure (up to \$5,000) also is imposed on a foundation manager who agrees to making a taxable expenditure knowing that it is a taxable expenditure. An additional tax of 50 percent of the amount of the expenditure (up to \$10,000) is imposed on a foundation manager who refuses to agree to correction of such expenditure.

Explanation of Provision

Self-dealing and excess benefit transaction initial taxes and dollar limitations

For acts of self-dealing by a private foundation to a disqualified person, the provision increases the initial tax on the self-dealer from five percent of the amount involved to 10 percent of the amount involved. The provision increases the initial tax on foundation managers from 2.5 percent of the amount involved to five percent of the amount involved and increases the dollar limitation on the amount of the initial and additional taxes on foundation managers per act of self-dealing from \$10,000 per act to \$20,000 per act. Similarly, the provision doubles the dollar limitation on organization managers of public charities and social welfare organizations for participation in excess benefit transactions from \$10,000 per transaction to \$20,000 per transaction.

Failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures

The provision doubles the amounts of the initial taxes and the dollar limitations on foundation managers with respect to the private foundation excise taxes on the failure to distribute income, excess business holdings, jeopardizing investments, and taxable expenditures.

³⁴² Sec. 4944(c).

³⁴³ Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

³⁴⁴ In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

Specifically, for the failure to distribute income, the initial tax on the foundation is increased from 15 percent of the undistributed amount to 30 percent of the undistributed amount.

For excess business holdings, the initial tax on excess business holdings is increased from five percent of the value of such holdings to 10 percent of such value.

For jeopardizing investments, the initial tax of five percent of the amount of the investment that is imposed on the foundation and on foundation managers is increased to 10 percent of the amount of the investment. The dollar limitation on the initial tax on foundation managers of \$5,000 per investment is increased to \$10,000 and the dollar limitation on the additional tax on foundation managers of \$10,000 per investment is increased to \$20,000.

For taxable expenditures, the initial tax on the foundation is increased from 10 percent of the amount of the expenditure to 20 percent, the initial tax on the foundation manager is increased from 2.5 percent of the amount of the expenditure to five percent, the dollar limitation on the initial tax on foundation managers is increased from \$5,000 to \$10,000, and the dollar limitation on the additional tax on foundation managers is increased from \$10,000 to \$20,000.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

3. Reform rules for charitable contributions of easements in registered historic districts and take account of rehabilitation credit in easement donations (sec. 170 of the Code)

Present Law

In general

Present law provides special rules that apply to charitable deductions of qualified conservation contributions, which include conservation easements and façade easements.³⁴⁵ Qualified conservation contributions are not subject to the “partial interest” rule, which generally bars deductions for charitable contributions of partial interests in property.³⁴⁶ Accordingly, qualified conservation contributions are contributions of partial interests that are eligible for a fair market value charitable deduction.

A qualified conservation contribution is a contribution of a qualified real property interest to a qualified organization exclusively for conservation purposes. A qualified real property interest is defined as: (1) the entire interest of the donor other than a qualified mineral interest; (2) a remainder interest; or (3) a restriction (granted in perpetuity) on the use that may be made

³⁴⁵ Sec. 170(h).

³⁴⁶ Sec. 170(f)(3).

of the real property.³⁴⁷ Qualified organizations include certain governmental units, public charities that meet certain public support tests, and certain supporting organizations.

Conservation purposes include: (1) the preservation of land areas for outdoor recreation by, or for the education of, the general public; (2) the protection of a relatively natural habitat of fish, wildlife, or plants, or similar ecosystem; (3) the preservation of open space (including farmland and forest land) where such preservation will yield a significant public benefit and is either for the scenic enjoyment of the general public or pursuant to a clearly delineated Federal, State, or local governmental conservation policy; and (4) the preservation of an historically important land area or a certified historic structure.³⁴⁸

In general, no deduction is available if the property may be put to a use that is inconsistent with the conservation purpose of the gift.³⁴⁹ A contribution is not deductible if it accomplishes a permitted conservation purpose while also destroying other significant conservation interests.³⁵⁰

Taxpayers are required to obtain a qualified appraisal for donated property with a value of \$5,000 or more, and to attach an appraisal summary to the tax return.³⁵¹ Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170;³⁵² (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.³⁵³

³⁴⁷ Charitable contributions of interests that constitute the taxpayer's entire interest in the property are not regarded as qualified real property interests within the meaning of section 170(h), but instead are subject to the general rules applicable to charitable contributions of entire interests of the taxpayer (i.e., generally are deductible at fair market value, without regard to satisfaction of the requirements of section 170(h)).

³⁴⁸ Sec. 170(h)(4)(A).

³⁴⁹ Treas. Reg. sec. 1.170A-14(e)(2).

³⁵⁰ Treas. Reg. sec. 1.170A-14(e)(2).

³⁵¹ Sec. 170(f)(11)(C).

³⁵² In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

³⁵³ Treas. Reg. sec. 1.170A-13(c)(3).

Valuation

The value of a conservation restriction granted in perpetuity generally is determined under the “before and after approach.” Such approach provides that the fair market value of the restriction is equal to the difference (if any) between the fair market value of the property the restriction encumbers before the restriction is granted and the fair market value of the encumbered property after the restriction is granted.³⁵⁴

If the granting of a perpetual restriction has the effect of increasing the value of any other property owned by the donor or a related person, the amount of the charitable deduction for the conservation contribution is to be reduced by the amount of the increase in the value of the other property.³⁵⁵ In addition, the donor is to reduce the amount of the charitable deduction by the amount of financial or economic benefits that the donor or a related person receives or can reasonably be expected to receive as a result of the contribution.³⁵⁶ If such benefits are greater than those that will inure to the general public from the transfer, no deduction is allowed.³⁵⁷ In those instances where the grant of a conservation restriction has no material effect on the value of the property, or serves to enhance, rather than reduce, the value of the property, no deduction is allowed.³⁵⁸

Preservation of a certified historic structure

A certified historic structure means any building, structure, or land which is (i) listed in the National Register, or (ii) located in a registered historic district (as defined in section 47(c)(3)(B)) and is certified by the Secretary of the Interior to the Secretary of the Treasury as being of historic significance to the district.³⁵⁹ For this purpose, a structure means any structure, whether or not it is depreciable, and, accordingly, easements on private residences may qualify.³⁶⁰ If restrictions to preserve a building or land area within a registered historic district permit future development on the site, a deduction will be allowed only if the terms of the restrictions require that such development conform with appropriate local, State, or Federal standards for construction or rehabilitation within the district.³⁶¹

³⁵⁴ Treas. Reg. sec. 1.170A-14(h)(3).

³⁵⁵ Treas. Reg. sec. 1.170A-14(h)(3)(i).

³⁵⁶ *Id.*

³⁵⁷ *Id.*

³⁵⁸ Treas. Reg. sec. 1.170A-14(h)(3)(ii).

³⁵⁹ Sec. 170(h)(4)(B).

³⁶⁰ Treas. Reg. sec. 1.170A-14(d)(5)(iii).

³⁶¹ Treas. Reg. sec. 1.170A-14(d)(5)(i).

The IRS and the courts have held that a facade easement may constitute a qualifying conservation contribution.³⁶² In general, a facade easement is a restriction the purpose of which is to preserve certain architectural, historic, and cultural features of the facade, or front, of a building. The terms of a facade easement might permit the property owner to make alterations to the facade of the structure if the owner obtains consent from the qualified organization that holds the easement.

Rehabilitation credit

In general, present law allows as part of the general business credit an investment tax credit.³⁶³ The amount of the investment tax credit includes the amount of a rehabilitation credit.³⁶⁴ The rehabilitation credit for any taxable year is the sum of ten percent of the qualified rehabilitation expenditures with respect to any qualified rehabilitated building other than a certified historic structure and 20 percent of the qualified rehabilitation expenditures with respect to any certified historic structure.³⁶⁵ In general, a qualified rehabilitated building is a depreciable building (and its structural components) if the building has been substantially rehabilitated, was placed in service before the beginning of the rehabilitation, and (except for a certified historic structure) in the rehabilitation process a certain percentage of the existing internal and external walls and internal structural framework are retained in place as internal and external walls and internal structural framework. A qualified rehabilitation expenditure is, in general, an amount properly chargeable to a capital account (i) for depreciable property that is nonresidential real property, residential rental property, real property that has a class life of more than 12.5 years, or an addition or improvement to any such property and (ii) in connection with the rehabilitation of a qualified rehabilitation building.

Explanation of Provision

Easements in registered historic districts

The provision revises the rules for qualified conservation contributions with respect to property for which a charitable deduction is allowable under section 170(h)(4)(B)(ii) by reason of a property's location in a registered historic district. Under the provision, a charitable deduction is not allowable with respect to a structure or land area located in such a district (by reason of the structure or land area's location in such a district). A charitable deduction is

³⁶² *Hillborn v. Commissioner*, 85 T.C. 677 (1985) (holding the fair market value of a facade donation generally is determined by applying the "before and after" valuation approach); *Richmond v. U.S.*, 699 F. Supp. 578 (E.D. La. 1988); Priv. Ltr. Rul. 199933029 (May 24, 1999) (ruling that a preservation and conservation easement relating to the facade and certain interior portions of a fraternity house was a qualified conservation contribution).

³⁶³ Sec. 38(b)(1).

³⁶⁴ Sec. 46.

³⁶⁵ Sec. 47(a).

allowable with respect to buildings (as is the case under present law) but the qualified real property interest that relates to the exterior of the building must preserve the entire exterior of the building, including the space above the building, the sides, the rear, and the front of the building. In addition, such qualified real property interest must provide that no portion of the exterior of the building may be changed in a manner inconsistent with the historical character of such exterior.

For any contribution relating to a registered historic district made after the date of enactment of the provision, taxpayers must include with the return for the taxable year of the contribution a qualified appraisal of the qualified real property interest (irrespective of the claimed value of such interest) and attach the appraisal with the taxpayer's return, photographs of the entire exterior of the building,³⁶⁶ and descriptions of all current restrictions on development of the building, including, for example, zoning laws, ordinances, neighborhood association rules, restrictive covenants, and other similar restrictions. Failure to obtain and attach an appraisal or to include the required information results in disallowance of the deduction. In addition, the donor and the donee must enter into a written agreement certifying, under penalty of perjury, that the donee is a qualified organization, with a purpose of environmental protection, land conservation, open space preservation, or historic preservation, and that the donee has the resources to manage and enforce the restriction and a commitment to do so.

Taxpayers claiming a deduction for a qualified conservation contribution with respect to the exterior of a building located in a registered historic district in excess of \$10,000 must pay a \$500 fee to the Internal Revenue Service or the deduction is not allowed. Amounts paid are required to be dedicated to Internal Revenue Service enforcement of qualified conservation contributions.

Reduction of deduction to take account of rehabilitation credit

The provision provides that in the case of any qualified conservation contribution, the amount of the deduction is reduced by an amount that bears the same ratio to the fair market value of the contribution as the sum of the rehabilitation credits under section 47 for the preceding five taxable years with respect to a building that is part of the contribution bears to the fair market value of the building on the date of the contribution. For example, if a taxpayer makes a qualified conservation contribution with respect to a building, and such taxpayer has claimed a rehabilitation credit with respect to such building in any of the five taxable years preceding the year in which the contribution is claimed, the taxpayer must reduce the amount of the contribution. If the aggregate amount of credits claimed by the taxpayer within such five year period is \$100,000, and the fair market value of the building with respect to which the contribution is made is \$1,000,000, the taxpayer must reduce the amount of the deduction by 10 percent (or 100,000 over 1,000,000).

³⁶⁶ Photographs of the entire exterior of the building are required to the extent practicable. For example, if the building is a skyscraper, aerial photographs of the roof would not be required, but photographs sufficient to establish the existing exterior still must be submitted.

Effective Date

The provisions relating to deductions for contributions relating to structures and land areas and to the rehabilitation credit are effective for contributions made after the date of enactment. The provision relating to a filing fee is effective for contributions made 180 days after the date of enactment. The rest of the provision is effective for contributions made after July 25, 2006.

4. Reform rules relating to charitable contributions of taxidermy (sec. 170 of the Code)

Present Law

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.³⁶⁷ The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.³⁶⁸ In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,³⁶⁹ though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a

³⁶⁷ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

³⁶⁸ Secs. 170(b) and (e).

³⁶⁹ Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;³⁷⁰ (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of taxidermy are subject to the tangible personal property rule (number (2) above). For example, for appreciated taxidermy, if the property is used to further the donee's exempt purpose, the deduction is fair market value. But if the property is not used to further the donee's exempt purpose, the deduction is the donor's basis. If the taxidermy is depreciated, i.e., the value is less than the taxpayer's basis in such property, taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Explanation of Provision

In general, the provision provides that the amount allowed as a deduction for charitable contributions of taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting) is the lesser of the taxpayer's basis in the property or the fair market value of the property. Specifically, a taxpayer that makes such a charitable contribution of taxidermy property for a use related to the donee's exempt purpose or function must, in determining the amount of the deduction, reduce the fair market value of the property by the amount of gain that would have been long-term capital gain if the property contributed had been sold by the taxpayer at its fair market value (determined at the time of the contribution). Taxidermy property is defined as any work of art that is the reproduction or preservation of an animal in whole or in part, is prepared, stuffed or mounted for purposes of recreating one or more characteristics of such animal, and contains a part of the body of the dead animal.

For purposes of determining a taxpayer's basis in taxidermy property that is contributed by the person who prepared, stuffed, or mounted the property (or by any person who paid or incurred the cost of such preparation, stuffing, or mounting), the provision provides a special rule that the basis of such property may include only the cost of the preparing, stuffing, or mounting. For purposes of the special rule, it is intended that only the direct costs of the preparing, stuffing, or mounting may be included in basis. Indirect costs, not included in the basis, include the costs of transportation relating to any aspect of the taxidermy or the hunting of the animal, and the direct or indirect costs relating to the hunting or killing of an animal (including the cost of equipment and the costs of preparing an animal carcass for taxidermy).

³⁷⁰ For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

Effective Date

The provision is effective for contributions made after July 25, 2006.

5. Recapture of tax benefit on property not used for an exempt use (new sec. 6720B of the Code)

Present Law

Deductibility of charitable contributions

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.³⁷¹ The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.³⁷² In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,³⁷³ though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset, or property used in the taxpayer's trade or business, the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations (i.e., limitations based on the donor's income) than other contributions of property.

³⁷¹ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

³⁷² Secs. 170(b) and (e).

³⁷³ Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-term capital gain if the property was sold by the taxpayer on the contribution date;³⁷⁴ (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Substantiation

No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization.³⁷⁵ Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution (and a good faith estimate of the value of any such goods or services).

In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.³⁷⁶ C corporations (other than personal service corporations and closely-held corporations) are required to file Form 8283 only if the deduction claimed is more than \$5,000. Information required on the Form 8283 includes, among other things, a description of the property, the appraised fair market value (if an appraisal is required), the donor's basis in the property, how the donor acquired the property, a declaration by the appraiser regarding the appraiser's general qualifications, an acknowledgement by the donee that it is eligible to receive deductible contributions, and an indication by the donee whether the property is intended for an unrelated use.

Taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.³⁷⁷ Under Treasury regulations, a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a

³⁷⁴ For certain contributions of inventory, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

³⁷⁵ Sec. 170(f)(8).

³⁷⁶ Sec. 170(f)(11).

³⁷⁷ *Id.*

deduction is first claimed under section 170,³⁷⁸ (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.³⁷⁹ In the case of contributions of art valued at more than \$20,000 and other contributions of more than \$500,000, taxpayers are required to attach the appraisal to the tax return. Taxpayers may request a Statement of Value from the Internal Revenue Service in order to substantiate the value of art with an appraised value of \$50,000 or more for income, estate, or gift tax purposes.³⁸⁰ The fee for such a Statement is \$2,500 for one, two, or three items or art plus \$250 for each additional item.

If a donee organization sells, exchanges, or otherwise disposes of contributed property with a claimed value of more than \$5,000 (other than publicly traded securities) within two years of the property's receipt, the donee is required to file a return (Form 8282) with the Secretary, and to furnish a copy of the return to the donor, showing the name, address, and taxpayer identification number of the donor, a description of the property, the date of the contribution, the amount received on the disposition, and the date of the disposition.³⁸¹

Explanation of Provision

In general, the provision recovers the tax benefit for charitable contributions of tangible personal property with respect to which a fair market value deduction is claimed and which is not used for exempt purposes. The provision applies to appreciated tangible personal property that is identified by the donee organization, for example on the Form 8283, as for a use related to the purpose or function constituting the donee's basis for tax exemption, and for which a deduction of more than \$5,000 is claimed ("applicable property").³⁸²

Under the provision, if a donee organization disposes of applicable property within three years of the contribution of the property, the donor is subject to an adjustment of the tax benefit. If the disposition occurs in the tax year of the donor in which the contribution is made, the donor's deduction generally is basis and not fair market value.³⁸³ If the disposition occurs in a

³⁷⁸ In the case of a deduction first claimed or reported on an amended return, the deadline is the date on which the amended return is filed.

³⁷⁹ Treas. Reg. sec. 1.170A-13(c)(3). Sec. 170(f)(11)(E).

³⁸⁰ Rev. Proc. 96-15, 1996-1 C.B. 627.

³⁸¹ Sec. 6050L(a)(1).

³⁸² Present law rules continue to apply to any contribution of exempt use property for which a deduction of \$5,000 or less is claimed.

³⁸³ The disposition proceeds are regarded as relevant to a determination of fair market value.

subsequent year, the donor must include as ordinary income for its taxable year in which the disposition occurs an amount equal to the excess (if any) of (i) the amount of the deduction previously claimed by the donor as a charitable contribution with respect to such property, over (ii) the donor's basis in such property at the time of the contribution.

There is no adjustment of the tax benefit if the donee organization makes a certification to the Secretary, by written statement signed under penalties of perjury by an officer of the organization. The statement must either (1) certify that the use of the property by the donee was related to the purpose or function constituting the basis for the donee's exemption, and describe how the property was used and how such use furthered such purpose or function; or (2) state the intended use of the property by the donee at the time of the contribution and certify that such use became impossible or infeasible to implement. The organization must furnish a copy of the certification to the donor (for example, as part of the Form 8282, a copy of which is supplied to the donor).

A penalty of \$10,000 applies to a person that identifies applicable property as having a use that is related to a purpose or function constituting the basis for the donee's exemption knowing that it is not intended for such a use.³⁸⁴

Reporting of exempt use property contributions

The provision modifies the present-law information return requirements that apply upon the disposition of contributed property by a charitable organization (Form 8282, sec. 6050L). The return requirement is extended to dispositions made within three years after receipt (from two years). The donee organization also must provide, in addition to the information already required to be provided on the return, a description of the donee's use of the property, a statement of whether use of the property was related to the purpose or function constituting the basis for the donee's exemption, and, if applicable, a certification of any such use (described above).

Effective Date

The provision is effective for contributions made and returns filed after September 1, 2006, and with respect to the penalty, for identifications made after the date of enactment.

³⁸⁴ Other present-law penalties also may apply, such as the penalty for aiding and abetting the understatement of tax liability under section 6701.

6. Limit charitable deduction for contributions of clothing and household items (sec. 170 of the Code)

Present Law

In general

In computing taxable income, a taxpayer who itemizes deductions generally is allowed to deduct the amount of cash and the fair market value of property contributed to an organization described in section 501(c)(3) or to a Federal, State, or local governmental entity.³⁸⁵ The amount of the deduction allowable for a taxable year with respect to a charitable contribution of property may be reduced or limited depending on the type of property contributed, the type of charitable organization to which the property is contributed, and the income of the taxpayer.³⁸⁶ In general, more generous charitable contribution deduction rules apply to gifts made to public charities than to gifts made to private foundations. Within certain limitations, donors also are entitled to deduct their contributions to section 501(c)(3) organizations for Federal estate and gift tax purposes. By contrast, contributions to nongovernmental, non-charitable tax-exempt organizations generally are not deductible by the donor,³⁸⁷ though such organizations are eligible for the exemption from Federal income tax with respect to such donations.

Contributions of property

The amount of the deduction for charitable contributions of capital gain property generally equals the fair market value of the contributed property on the date of the contribution. Capital gain property means any capital asset or property used in the taxpayer's trade or business the sale of which at its fair market value, at the time of contribution, would have resulted in gain that would have been long-term capital gain. Contributions of capital gain property are subject to different percentage limitations than other contributions of property.

For certain contributions of property, the deductible amount is reduced from the fair market value of the contributed property by the amount of any gain, generally resulting in a deduction equal to the taxpayer's basis. This rule applies to contributions of: (1) ordinary income property, e.g., property that, at the time of contribution, would not have resulted in long-

³⁸⁵ The deduction also is allowed for purposes of calculating alternative minimum taxable income.

³⁸⁶ Secs. 170(b) and (e).

³⁸⁷ Exceptions to the general rule of non-deductibility include certain gifts made to a veterans' organization or to a domestic fraternal society. In addition, contributions to certain nonprofit cemetery companies are deductible for Federal income tax purposes, but generally are not deductible for Federal estate and gift tax purposes. Secs. 170(c)(3), 170(c)(4), 170(c)(5), 2055(a)(3), 2055(a)(4), 2106(a)(2)(A)(iii), 2522(a)(3), and 2522(a)(4).

term capital gain if the property was sold by the taxpayer on the contribution date;³⁸⁸ (2) tangible personal property that is used by the donee in a manner unrelated to the donee's exempt (or governmental) purpose; and (3) property to or for the use of a private foundation (other than a foundation defined in section 170(b)(1)(E)).

Charitable contributions of clothing and household items are subject to the tangible personal property rule (number (2) above). If such contributed property is appreciated property in the hands of the taxpayer, and is not used to further the donee's exempt purpose, the deduction is basis. In general, however, the value of clothing and household items is less than the taxpayer's basis in such property, with the result that taxpayers generally deduct the fair market value of such contributions, regardless of whether the property is used for exempt or unrelated purposes by the donee.

Substantiation

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.³⁸⁹ A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.³⁹⁰

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such

³⁸⁸ For certain contributions of inventory and other property, C corporations may claim an enhanced deduction equal to the lesser of (1) basis plus one-half of the item's appreciation (i.e., basis plus one half of fair market value in excess of basis) or (2) two times basis. Sec. 170(e)(3), 170(e)(4), 170(e)(6).

³⁸⁹ Treas. Reg. sec. 1.170A-13(a).

³⁹⁰ Treas. Reg. sec. 1.170A-13(b).

goods or services.³⁹¹ In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.³⁹² In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

Explanation of Provision

The provision provides that no deduction is allowed for a charitable contribution of clothing or household items unless the clothing or household item is in good used condition or better. The Secretary is authorized to deny by regulation a deduction for any contribution of clothing or a household item that has minimal monetary value, such as used socks and used undergarments. It is noted that the President's Advisory Panel on Federal Tax Reform and the staff of the Joint Committee on Taxation both have concluded that the fair market value-based deduction for contributions of clothing and household items present difficult tax administration issues, as determining the correct value of an item is a fact intensive, and thus also a resource intensive matter.³⁹³ As recently reported by the IRS, the amount claimed as deductions in tax year 2003 for clothing and household items was more than \$9 billion.³⁹⁴ It is expected that the Secretary, in consultation with affected charities, will exercise assiduously the authority to disallow a deduction for some items of low value, consistent with the goals of improving tax administration and ensure that donated clothing and household items are of meaningful use to charitable organizations.

Under the provision, a deduction may be allowed for a charitable contribution of an item of clothing or a household item not in good used condition or better if the amount claimed for the item is more than \$500 and the taxpayer includes with the taxpayer's return a qualified appraisal with respect to the property. Household items include furniture, furnishings, electronics, appliances, linens, and other similar items. Food, paintings, antiques, and other objects of art, jewelry and gems, and collections are excluded from the provision.

Effective Date

The provision is effective for contributions made after the date of enactment.

³⁹¹ Sec. 170(f)(8).

³⁹² Sec. 170(f)(11).

³⁹³ See *The President's Advisory Panel on Federal Tax Reform*, 78 (2005); Joint Committee on Taxation, *Options to Improve Tax Compliance and Reform Tax Expenditures* 288 (JCS-02-05), January 27, 2005.

³⁹⁴ Internal Revenue Service, Statistics of Income Division, *Individual Noncash Charitable Contributions, 2003*, Figure A (Spring 2006).

7. Modify recordkeeping and substantiation requirements for certain charitable contributions (sec. 170 of the Code)

Present Law

A donor who claims a deduction for a charitable contribution must maintain reliable written records regarding the contribution, regardless of the value or amount of such contribution. For a contribution of money, the donor generally must maintain one of the following: (1) a cancelled check; (2) a receipt (or a letter or other written communication) from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution; or (3) in the absence of a cancelled check or a receipt, other reliable written records showing the name of the donee, the date of the contribution, and the amount of the contribution. For a contribution of property other than money, the donor generally must maintain a receipt from the donee organization showing the name of the donee, the date and location of the contribution, and a detailed description (but not the value) of the property.³⁹⁵ A donor of property other than money need not obtain a receipt, however, if circumstances make obtaining a receipt impracticable. Under such circumstances, the donor must maintain reliable written records regarding the contribution. The required content of such a record varies depending upon factors such as the type and value of property contributed.³⁹⁶

In addition to the foregoing recordkeeping requirements, substantiation requirements apply in the case of charitable contributions with a value of \$250 or more. No charitable deduction is allowed for any contribution of \$250 or more unless the taxpayer substantiates the contribution by a contemporaneous written acknowledgement of the contribution by the donee organization. Such acknowledgement must include the amount of cash and a description (but not value) of any property other than cash contributed, whether the donee provided any goods or services in consideration for the contribution, and a good faith estimate of the value of any such goods or services.³⁹⁷ In general, if the total charitable deduction claimed for non-cash property is more than \$500, the taxpayer must attach a completed Form 8283 (Noncash Charitable Contributions) to the taxpayer's return or the deduction is not allowed.³⁹⁸ In general, taxpayers are required to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.

Explanation of Provision

The provision more closely aligns the substantiation rules for money to the substantiation rules for property by providing that in the case of a charitable contribution of money, regardless of the amount, applicable recordkeeping requirements are satisfied only if the donor maintains as

³⁹⁵ Treas. Reg. sec. 1.170A-13(a).

³⁹⁶ Treas. Reg. sec. 1.170A-13(b).

³⁹⁷ Sec. 170(f)(8).

³⁹⁸ Sec. 170(f)(11).

a record of the contribution a bank record or a written communication from the donee showing the name of the donee organization, the date of the contribution, and the amount of the contribution. The recordkeeping requirements may not be satisfied by maintaining other written records. It is noted that currently, taxpayers are required to have a contemporaneous record of contributions of money, but that many taxpayers may not be aware of the requirement and do not keep a log of such contributions. The provision is intended to provide greater certainty, both to taxpayers and to the Secretary, in determining what may be deducted as a charitable contribution.

Effective Date

The provision is effective for contributions made in taxable years beginning after the date of enactment.

8. Contributions of fractional interests in tangible personal property (secs. 170, 2055, and 2522 of the Code)

Present Law

In general, a charitable deduction is not allowable for a contribution of a partial interest in property, such as an income interest, a remainder interest, or a right to use property.³⁹⁹ A gift of an undivided portion of a donor's entire interest in property generally is not treated as a nondeductible gift of a partial interest in property.⁴⁰⁰ For this purpose, an undivided portion of a donor's entire interest in property must consist of a fraction or percentage of each and every substantial interest or right owned by the donor in such property and must extend over the entire term of the donor's interest in such property.⁴⁰¹ A gift generally is treated as a gift of an undivided portion of a donor's entire interest in property if the donee is given the right, as a tenant in common with the donor, to possession, dominion, and control of the property for a portion of each year appropriate to its interest in such property.⁴⁰²

A charitable contribution deduction generally is not allowable for a contribution of a future interest in tangible personal property.⁴⁰³ For this purpose, a future interest is one "in which a donor purports to give tangible personal property to a charitable organization, but has an understanding, arrangement, agreement, etc., whether written or oral, with the charitable organization which has the effect of reserving to, or retaining in, such donor a right to the use, possession, or enjoyment of the property."⁴⁰⁴ Treasury regulations provide that section

³⁹⁹ Secs. 170(f)(3)(A) (income tax), 2055(e)(2) (estate tax), and 2522(c)(2) (gift tax).

⁴⁰⁰ Sec. 170(f)(3)(B)(ii).

⁴⁰¹ Treas. Reg. sec. 1.170A-7(b)(1).

⁴⁰² Treas. Reg. sec. 1.170A-7(b)(1).

⁴⁰³ Sec. 170(a)(3).

⁴⁰⁴ Treas. Reg. sec. 1.170A-5(a)(4).

170(a)(3), which generally denies a deduction for a contribution of a future interest in tangible personal property, “[has] no application in respect of a transfer of an undivided present interest in property. For example, a contribution of an undivided one-quarter interest in a painting with respect to which the donee is entitled to possession during three months of each year shall be treated as made upon the receipt by the donee of a formally executed and acknowledged deed of gift. However, the period of initial possession by the donee may not be deferred in time for more than one year.”⁴⁰⁵

Explanation of Provision

In general, under present law and the provision a donor may take a deduction for a charitable contribution of a fractional interest in tangible personal property (such as an artwork), provided the donor satisfies the requirements for deductibility (including the requirements concerning contributions of partial interests and future interests in property), and in subsequent years make additional charitable contributions of interests in the same property.⁴⁰⁶ Under the provision, the value of a donor’s charitable deduction for the initial contribution of a fractional interest in an item of tangible personal property (or collection of such items) shall be determined as under current law (e.g., based upon the fair market value of the artwork at the time of the contribution of the fractional interest and considering whether the use of the artwork will be related to the donee’s exempt purposes). For purposes of determining the deductible amount of each additional contribution of an interest (whether or not a fractional interest) in the same item of property, the fair market value of the item is the lesser of: (1) the value used for purposes of determining the charitable deduction for the initial fractional contribution; or (2) the fair market value of the item at the time of the subsequent contribution. This portion of the provision applies for income, gift, and estate tax purposes.

The provision provides for recapture of the income tax charitable deduction and gift tax charitable deduction under certain circumstances. First, if a donor makes an initial fractional contribution, then fails to contribute all of the donor’s remaining interest in such property to the same donee before the earlier of 10 years from the initial fractional contribution or the donor’s death, then the donee’s charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If the donee of the initial contribution is no longer in existence as of such time, the donor’s remaining interest may be contributed to another organization described in section 170(c) (which describes organizations to which contributions that are deductible for income tax purposes may be made). Second, if the donee of a fractional interest in an item of tangible personal property fails to take substantial physical possession of the item during the period described above (the possession requirement) or fails to use the property for an exempt use during the period described above (the related-use requirement), then the donee’s charitable income and gift tax deductions for all previous contributions of interests in the item shall be recaptured (plus interest). If, for example, an art museum described in section 501(c)(3) that is the donee of a fractional interest in a painting

⁴⁰⁵ Treas. Reg. sec. 1.170A-5(a)(2).

⁴⁰⁶ See, e.g., *Winokur v. Commissioner*, 90 T.C. 733 (1988).

includes the painting in an art exhibit sponsored by the museum, such use generally will be treated as satisfying the related-use requirement of the provision.

In any case in which there is a recapture of a deduction as described in the preceding paragraph, the provision also imposes an additional tax in an amount equal to 10 percent of the amount recaptured.

Under the provision, no income or gift tax charitable deduction is allowed for a contribution of a fractional interest in an item of tangible personal property unless immediately before such contribution all interests in the item are owned (1) by the donor or (2) by the donor and the donee organization. The Secretary is authorized to make exceptions to this rule in cases where all persons who hold an interest in the item make proportional contributions of undivided interests in their respective shares of such item to the donee organization. For example, if A owns an undivided 40 percent interest in a painting and B owns an undivided 60 percent interest in the same painting, the Secretary may provide that A may take a deduction for a charitable contribution of less than the entire interest held by A, provided that both A and B make proportional contributions of undivided fractional interests in their respective shares of the painting to the same donee organization (e.g., if A contributes 50 percent of A's interest and B contributes 50 percent of B's interest).

It is intended that a contribution occurring before the date of enactment not be treated as an initial fractional contribution for purposes of the provision. Instead, the first fractional contribution by a taxpayer after the date of enactment would be considered the initial fractional contribution under the provision, regardless of whether the taxpayer had made a contribution of a fractional interest in the same item of tangible personal property prior to the date of enactment.

Effective Date

The provision is applicable for contributions, bequests, and gifts made after the date of enactment.

9. Proposals relating to appraisers and substantial and gross overstatement of valuations of property (secs. 170, 6662, 6664, 6696 and new sec. 6695A of the Code)

Present Law

Taxpayer penalties

Present law imposes accuracy-related penalties on a taxpayer in cases involving a substantial valuation misstatement or gross valuation misstatement relating to an underpayment of income tax.⁴⁰⁷ For this purpose, a substantial valuation misstatement generally means a value claimed that is at least twice (200 percent or more) the amount determined to be the correct value, and a gross valuation misstatement generally means a value claimed that is at least four times (400 percent or more) the amount determined to be the correct value.

⁴⁰⁷ Sec. 6662(b)(3) and (h).

The penalty is 20 percent of the underpayment of tax resulting from a substantial valuation misstatement and rises to 40 percent for a gross valuation misstatement. No penalty is imposed unless the portion of the underpayment attributable to the valuation misstatement exceeds \$5,000 (\$10,000 in the case of a corporation other than an S corporation or a personal holding company). Under present law, no penalty is imposed with respect to any portion of the understatement attributable to any item if (1) the treatment of the item on the return is or was supported by substantial authority, or (2) facts relevant to the tax treatment of the item were adequately disclosed on the return or on a statement attached to the return and there is a reasonable basis for the tax treatment. Special rules apply to tax shelters.

Present law also imposes an accuracy-related penalty on substantial or gross estate or gift tax valuation understatements.⁴⁰⁸ In general, there is a substantial estate or gift tax understatement if the value of any property claimed on any return is 50 percent or less of the amount determined to be the correct amount, and a gross estate or gift tax understatement if such value is 25 percent or less of the amount determined to be the correct amount.

In addition, the accuracy-related penalties do not apply if a taxpayer shows there was reasonable cause for an underpayment and the taxpayer acted in good faith.⁴⁰⁹

Penalty for aiding and abetting understatement of tax

A penalty is imposed on a person who: (1) aids or assists in or advises with respect to a tax return or other document; (2) knows (or has reason to believe) that such document will be used in connection with a material tax matter; and (3) knows that this would result in an understatement of tax of another person. In general, the amount of the penalty is \$1,000. If the document relates to the tax return of a corporation, the amount of the penalty is \$10,000.

Qualified appraisals

Present law requires a taxpayer to obtain a qualified appraisal for donated property with a value of more than \$5,000, and to attach an appraisal summary to the tax return.⁴¹⁰ Treasury Regulations state that a qualified appraisal means an appraisal document that, among other things: (1) relates to an appraisal that is made not earlier than 60 days prior to the date of contribution of the appraised property and not later than the due date (including extensions) of the return on which a deduction is first claimed under section 170; (2) is prepared, signed, and dated by a qualified appraiser; (3) includes (a) a description of the property appraised; (b) the fair market value of such property on the date of contribution and the specific basis for the valuation; (c) a statement that such appraisal was prepared for income tax purposes; (d) the qualifications of

⁴⁰⁸ Sec. 6662(g) and (h).

⁴⁰⁹ Sec. 6664(c).

⁴¹⁰ Sec. 170(f)(11).

the qualified appraiser; and (e) the signature and taxpayer identification number of such appraiser; and (4) does not involve an appraisal fee that violates certain prescribed rules.⁴¹¹

Qualified appraisers

Treasury Regulations define a qualified appraiser as a person who holds himself or herself out to the public as an appraiser or performs appraisals on a regular basis, is qualified to make appraisals of the type of property being valued (as determined by the appraiser's background, experience, education and membership, if any, in professional appraisal associations), is independent, and understands that an intentionally false or fraudulent overstatement of the value of the appraised property may subject the appraiser to civil penalties.⁴¹²

Appraiser oversight

The Secretary is authorized to regulate the practice of representatives of persons before the Department of the Treasury ("Department").⁴¹³ After notice and hearing, the Secretary is authorized to suspend or disbar from practice before the Department or the Internal Revenue Service ("IRS") a representative who is incompetent, who is disreputable, who violates the rules regulating practice before the Department or the IRS, or who (with intent to defraud) willfully and knowingly misleads or threatens the person being represented (or a person who may be represented).

The Secretary also is authorized to bar from appearing before the Department or the IRS, for the purpose of offering opinion evidence on the value of property or other assets, any individual against whom a civil penalty for aiding and abetting the understatement of tax has been assessed. Thus, an appraiser who aids or assists in the preparation or presentation of an appraisal will be subject to disciplinary action if the appraiser knows that the appraisal will be used in connection with the tax laws and will result in an understatement of the tax liability of another person. The Secretary has authority to provide that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Explanation of Provision

Taxpayer penalties

The provision lowers the thresholds for imposing accuracy-related penalties on a taxpayer. Under the provision, a substantial valuation misstatement exists when the claimed value of any property is 150 percent or more of the amount determined to be the correct value. A

⁴¹¹ Treas. Reg. sec. 1.170A-13(c)(3).

⁴¹² Treas. Reg. sec. 1.170A-13(c)(5)(i).

⁴¹³ 31 U.S.C. sec. 330.

gross valuation misstatement occurs when the claimed value of any property is 200 percent or more of the amount determined to be the correct value.

The provision tightens the thresholds for imposing accuracy-related penalties with respect to the estate or gift tax. Under the provision, a substantial estate or gift tax valuation misstatement exists when the claimed value of any property is 65 percent or less of the amount determined to be the correct value. A gross estate or gift tax valuation misstatement exists when the claimed value of any property is 40 percent or less of the amount determined to be the correct value.

Under the provision, the reasonable cause exception to the accuracy-related penalty does not apply in the case of gross valuation misstatements.

Appraiser oversight

Appraiser penalties

The provision establishes a civil penalty on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement. The penalty is equal to the greater of \$1,000 or 10 percent of the understatement of tax resulting from a substantial or gross valuation misstatement, up to a maximum of 125 percent of the gross income derived from the appraisal. Under the provision, the penalty does not apply if the appraiser establishes that it was “more likely than not” that the appraisal was correct.

Disciplinary proceeding

The provision eliminates the requirement that the Secretary assess against an appraiser the civil penalty for aiding and abetting the understatement of tax before such appraiser may be subject to disciplinary action. Thus, the Secretary is authorized to discipline appraisers after notice and hearing. Disciplinary action may include, but is not limited to, suspending or barring an appraiser from: preparing or presenting appraisals on the value of property or other assets to the Department or the IRS; appearing before the Department or the IRS for the purpose of offering opinion evidence on the value of property or other assets; and providing that the appraisals of an appraiser who has been disciplined have no probative effect in any administrative proceeding before the Department or the IRS.

Qualified appraisers

The provision defines a qualified appraiser as an individual who (1) has earned an appraisal designation from a recognized professional appraiser organization or has otherwise met minimum education and experience requirements to be determined by the IRS in regulations; (2) regularly performs appraisals for which he or she receives compensation; (3) can demonstrate verifiable education and experience in valuing the type of property for which the appraisal is being performed; (4) has not been prohibited from practicing before the IRS by the Secretary at any time during the three years preceding the conduct of the appraisal; and (5) is not excluded from being a qualified appraiser under applicable Treasury regulations.

Qualified appraisals

The provision defines a qualified appraisal as an appraisal of property prepared by a qualified appraiser (as defined by the provision) in accordance with generally accepted appraisal standards and any regulations or other guidance prescribed by the Secretary.

Effective Date

The provision amending the accuracy-related penalty applies to returns filed after the date of enactment. The provision establishing a civil penalty that may be imposed on any person who prepares an appraisal that is to be used to support a tax position if such appraisal results in a substantial or gross valuation misstatement applies to appraisals prepared with respect to returns or submissions filed after the date of enactment. The provisions relating to appraiser oversight apply to appraisals prepared with respect to returns or submissions filed after the date of enactment. With respect to any contribution of a qualified real property interest which is a restriction with respect to the exterior of a building described in section 170(h)(4)(C)(ii) (currently designated section 170(h)(4)(B)(ii), relating to certain property located in a registered historic district and certified as being of historic significance to the district), and any appraisal with respect to such contribution, the provision generally applies to returns filed after July 25, 2006.

10. Establish additional exemption standards for credit counseling organizations (secs. 501 and 513 of the Code)

Present Law

Under present law, a credit counseling organization may be exempt as a charitable or educational organization described in section 501(c)(3), or as a social welfare organization described in section 501(c)(4). The IRS has issued two revenue rulings holding that certain credit counseling organizations are exempt as charitable or educational organizations or as social welfare organizations.

In Revenue Ruling 65-299,⁴¹⁴ an organization whose purpose was to assist families and individuals with financial problems, and help reduce the incidence of personal bankruptcy, was determined to be a social welfare organization described in section 501(c)(4). The organization counseled people in financial difficulties, advised applicants on payment of debts, and negotiated with creditors and set up debt repayment plans. The organization did not restrict its services to the poor, made no charge for counseling services, and made a nominal charge for certain services to cover postage and supplies. For financial support, the organization relied on voluntary contributions from local businesses, lending agencies, and labor unions.

⁴¹⁴ Rev. Rul. 65-299, 1965-2 C.B. 165.

In Revenue Ruling 69-441,⁴¹⁵ the IRS ruled an organization was a charitable or educational organization exempt under section 501(c)(3) by virtue of aiding low-income people who had financial problems and providing education to the public. The organization in that ruling had two functions: (1) educating the public on personal money management, such as budgeting, buying practices, and the sound use of consumer credit through the use of films, speakers, and publications; and (2) providing individual counseling to low-income individuals and families without charge. As part of its counseling activities, the organization established debt management plans for clients who required such services, at no charge to the clients.⁴¹⁶ The organization was supported by contributions primarily from creditors, and its board of directors was comprised of representatives from religious organizations, civic groups, labor unions, business groups, and educational institutions.

In 1976, the IRS denied exempt status to an organization, Consumer Credit Counseling Service of Alabama, whose activities were distinguishable from those in Revenue Ruling 69-441 in that (1) it did not restrict its services to the poor, and (2) it charged a nominal fee for its debt management plans.⁴¹⁷ The organization provided free information to the general public through the use of speakers, films, and publications on the subjects of budgeting, buying practices, and the use of consumer credit. It also provided counseling to debt-distressed individuals, not necessarily poor or low-income, and provided debt management plans at the cost of \$10 per month, which was waived in cases of financial hardship. Its debt management activities were a relatively small part of its overall activities. The district court determined the organization qualified as charitable and educational within section 501(c)(3), finding the debt management plans to be an integral part of the agency's counseling function, and that its debt management activities were incidental to its principal functions, as only approximately 12 percent of the counselors' time was applied to such programs and the charge for the service was nominal. The court also considered the facts that the agency was publicly supported, and that it had a board dominated by members of the general public, as factors indicating a charitable operation.⁴¹⁸

A recent estimate shows the number of credit counseling organizations increased from approximately 200 in 1990 to over 1,000 in 2002.⁴¹⁹ During the period from 1994 to late 2003,

⁴¹⁵ Rev. Rul. 69-441, 1969-2 C.B. 115.

⁴¹⁶ Debt management plans are debt payment arrangements, including debt consolidation arrangements, entered into by a debtor and one or more of the debtor's creditors, generally structured to reduce the amount of a debtor's regular ongoing payment by modifying the interest rate, minimum payment, maturity or other terms of the debt. Such plans frequently are promoted as a means for a debtor to restructure debt without filing for bankruptcy.

⁴¹⁷ *Consumer Credit Counseling Service of Alabama, Inc. v. U.S.*, 44 A.F.T.R. 2d (RIA) 5122 (D.D.C. 1978). The case involved 24 agencies throughout the United States.

⁴¹⁸ *See also, Credit Counseling Centers of Oklahoma, Inc., v. U.S.*, 45 A.F.T.R. 2d (RIA) 1401 (D.D.C. 1979) (holding the same on virtually identical facts).

⁴¹⁹ Opening Statement of The Honorable Max Sandlin, Hearing on Non-Profit Credit Counseling Organizations, House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

1,215 credit counseling organizations applied to the IRS for tax exempt status under section 501(c)(3), including 810 during 2000 to 2003.⁴²⁰ The IRS has recognized more than 850 credit counseling organizations as tax exempt under section 501(c)(3).⁴²¹ Few credit counseling organizations have sought section 501(c)(4) status, and the IRS reports it has not seen any significant increase in the number or activity of such organizations operating as social welfare organizations.⁴²² As of late 2003, there were 872 active tax-exempt credit counseling agencies operating in the United States.⁴²³

A credit counseling organization described in section 501(c)(3) is exempt from certain Federal and State consumer protection laws that provide exemptions for organizations described therein.⁴²⁴ Some believe that these exclusions from Federal and State regulation may be a primary motivation for the recent increase in the number of organizations seeking and obtaining exempt status under section 501(c)(3).⁴²⁵ Such regulatory exemptions generally are not available for social welfare organizations described in section 501(c)(4).

⁴²⁰ United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003, to the Subcommittee from IRS Commissioner Everson).

⁴²¹ Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

⁴²² Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

⁴²³ United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations' Hearing on March 24, 2004, p. 3 (citing letter dated December 18, 2003 to the Subcommittee from IRS Commissioner Everson).

⁴²⁴ *E.g.*, The Credit Repair Organizations Act, 15 U.S.C. section 1679 *et seq.*, effective April 1, 1997 (imposing restrictions on credit repair organizations that are enforced by the Federal Trade Commission, including forbidding the making of untrue or misleading statements and forbidding advance payments; section 501(c)(3) organizations are explicitly exempt from such regulation). Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003) (California's consumer protections laws that impose strict standards on credit service organizations and the credit repair industry do not apply to nonprofit organizations that have received a final determination from the IRS that they are exempt from tax under section 501(c)(3) and are not private foundations).

⁴²⁵ Testimony of Commissioner Mark Everson before the House Ways and Means Committee, Subcommittee on Oversight (November 20, 2003).

Congress recently conducted hearings investigating the activities of credit counseling organizations under various consumer protection laws,⁴²⁶ such as the Federal Trade Commission Act.⁴²⁷ In addition, the IRS commenced a broad examination and compliance program with respect to the credit counseling industry. On May 15, 2006, the IRS announced that over the past two years, it had been auditing 63 credit counseling agencies, representing more than 40 percent of the revenue in the industry. Audits of 41 organizations, representing more than 40 percent of the revenue in the industry have been completed as of that date. All of such completed audits resulted in revocation, proposed revocation, or other termination of tax-exempt status.⁴²⁸ In addition, the IRS released two legal documents that provide a legal framework for determining the exempt status and related issues with respect to credit counseling organizations.⁴²⁹ In CCA 200620001, the IRS found that “[t]he critical inquiry is whether a credit counseling organization conducts its counseling program to improve an individual debtor’s understanding of his financial problems and improve his ability to address those problems.” The CCA concluded that whether a credit counseling organization primarily furthers educational purposes

can be determined by assessing the methodology by which the organization conducts its counseling activities. The process an organization uses to interview clients and develop recommendations, train its counselors and market its services can distinguish between an organization whose object is to improve a person’s knowledge and skills to manage his personal debt, and an organization that is offering counseling primarily as a mechanism to enroll individuals in a specific option (e.g., debt management plans) without considering the individual’s best interest.

Under the Bankruptcy Abuse Prevention and Consumer Protection Act of 2005, Public Law 109-8, an individual generally may not be a debtor in bankruptcy unless such individual has, within 180 days of filing a petition for bankruptcy, received from an approved nonprofit budget and credit counseling agency an individual or group briefing that outlines the opportunities for available credit counseling and assists the individual in performing a related

⁴²⁶ United States Senate Permanent Subcommittee on Investigations, Committee on Governmental Affairs, *Profiteering in a Non-Profit Industry: Abusive Practices in Credit Counseling*, Report Prepared by the Majority & Minority Staffs of the Permanent Subcommittee on Investigations and Released in Conjunction with the Permanent Subcommittee Investigations’ Hearing on March 24, 2004.

⁴²⁷ 15 U.S.C. sec. 45(a) (prohibiting unfair and deceptive acts or practices in or affecting commerce; although the Federal Trade Commission generally lacks jurisdiction to enforce consumer protection laws against bona fide nonprofit organizations, it may assert jurisdiction over a nonprofit, including a credit counseling organization, if it demonstrates the organization is organized to carry on business for profit, is a mere instrumentality of a for-profit entity, or operates through a common enterprise with one or more for-profit entities).

⁴²⁸ IRS News Release, IR-2006-80, May 15, 2006.

⁴²⁹ Chief Counsel Advice 200431023 (July 13, 2004); Chief Counsel Advice 200620001 (May 9, 2006).

budget analysis.⁴³⁰ The clerk of the court must maintain a publicly available list of nonprofit budget and credit counseling agencies approved by the U.S. Trustee (or bankruptcy administrator). In general, the U.S. Trustee (or bankruptcy administrator) shall only approve an agency that demonstrates that it will provide qualified counselors, maintain adequate provision for safekeeping and payment of client funds, provide adequate counseling with respect to client credit problems, and deal responsibly and effectively with other matters relating to the quality, effectiveness, and financial security of the services it provides. The minimum qualifications for approval of such an agency include: (1) in general, having an independent board of directors; (2) charging no more than a reasonable fee, and providing services without regard to ability to pay; (3) adequate provision for safekeeping and payment of client funds; (4) provision of full disclosures to clients; (5) provision of adequate counseling with respect to a client's credit problems; (6) trained counselors who receive no commissions or bonuses based on the outcome of the counseling services; (7) experience and background in providing credit counseling; and (8) adequate financial resources to provide continuing support services for budgeting plans over the life of any repayment plan. An individual debtor must file with the court a certificate from the approved nonprofit budget and credit counseling agency that provided the required services describing the services provided, and a copy of the debt management plan, if any, developed through the agency.⁴³¹

Explanation of Provision

Requirements for exempt status of credit counseling organizations

The provision establishes standards that a credit counseling organization must satisfy, in addition to present law requirements, in order to be organized and operated either as an organization described in section 501(c)(3) or in section 501(c)(4). The provision does not diminish the requirements set forth recently by the IRS in Chief Counsel Advice 200431023 or Chief Counsel Advice 200620001 but builds on and is consistent with such requirements, and the analysis therein. The provision is not intended to raise any question about IRS actions taken, and the IRS is expected to continue its vigorous examination of the credit counseling industry, applying the additional standards provided by the provision. The provision does not and is not intended to affect the approval process for credit counseling agencies under Public Law 109-8. Public Law 109-8 requires that an approved credit counseling agency be a nonprofit, and does not require that an approved agency be a section 501(c)(3) organization. It is expected that the

⁴³⁰ This requirement does not apply in certain circumstances, such as: (1) in general, where a debtor resides in a district for which the U.S. Trustee has determined that the approved counseling agencies for such district are not reasonably able to provide adequate services to additional individuals; (2) where exigent circumstances merit a waiver, the individual seeking bankruptcy protection files an appropriate certification with the court, and the certification is acceptable to the court; and (3) in general, where a court determines, after notice and hearing, that the individual is unable to complete the requirement because of incapacity, disability, or active military duty in a military combat zone.

⁴³¹ The Act also requires that, prior to discharge of indebtedness under chapter 7 or chapter 13, a debtor complete an approved instructional course concerning personal financial management, which course need not be conducted by a nonprofit agency.

Department of Justice shall continue to approve agencies for purposes of providing pre-bankruptcy counseling based on criteria that are consistent with such Public Law.

Under the provision, an organization that provides credit counseling services as a substantial purpose of the organization (“credit counseling organization”) is eligible for exemption from Federal income tax only as a charitable or educational organization under section 501(c)(3) or as a social welfare organization under section 501(c)(4), and only if (in addition to present-law requirements) the credit counseling organization is organized and operated in accordance with the following:

1. The organization provides credit counseling services tailored to the specific needs and circumstances of the consumer;
2. The organization makes no loans to debtors (other than loans with no fees or interest) and does not negotiate the making of loans on behalf of debtors;⁴³²
3. The organization provides services for the purpose of improving a consumer’s credit record, credit history, or credit rating only to the extent that such services are incidental to providing credit counseling services and does not charge any separately stated fee for any such services;⁴³³
4. The organization does not refuse to provide credit counseling services to a consumer due to inability of the consumer to pay, the ineligibility of the consumer for debt management plan enrollment, or the unwillingness of a consumer to enroll in a debt management plan;
5. The organization establishes and implements a fee policy to require that any fees charged to a consumer for its services are reasonable,⁴³⁴ allows for the waiver of fees if the consumer is unable to pay, and except to the extent allowed by State law prohibits charging any fee based in whole or in part on a percentage of the consumer’s debt, the consumer’s payments to be made pursuant to a debt management plan, or on the projected or actual savings to the consumer resulting from enrolling in a debt management plan;

⁴³² In general, negotiation of a loan involves negotiation of the terms of a loan, rather than the processing of a loan. Organizations that provide assistance to consumers to obtain a loan from the Department of Housing and Urban Development, for example, are not necessarily negotiating a loan for a consumer.

⁴³³ Accordingly, a credit counseling organization may provide credit repair type services, but only to the extent that the provision of such services is a direct outgrowth of the provision of credit counseling services.

⁴³⁴ Whether a credit counseling organization’s fees are consistent with specific State law requirements is evidence of the reasonableness of fees but is not determinative.

6. The organization at all times has a board of directors or other governing body (a) that is controlled by persons who represent the broad interests of the public, such as public officials acting in their capacities as such, persons having special knowledge or expertise in credit or financial education, and community leaders; (b) not more than 20 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees or the repayment of consumer debt to creditors other than the credit counseling organization or its affiliates) and (c) not more than 49 percent of the voting power of which is vested in persons who are employed by the organization or who will benefit financially, directly or indirectly, from the organization's activities (other than through the receipt of reasonable directors' fees);⁴³⁵
7. The organization does not own (except with respect to a section 501(c)(3) organization) more than 35 percent of the total combined voting power of a corporation (or profits or beneficial interest in the case of a partnership or trust or estate) that is in the trade or business of lending money, repairing credit, or providing debt management plan services, payment processing, and similar services; and
8. The organization receives no amount for providing referrals to others for debt management plan services, and pays no amount to others for obtaining referrals of consumers.⁴³⁶

Additional requirements for charitable and educational organizations

Under the provision, a credit counseling organization is described in section 501(c)(3) only if, in addition to satisfying the above requirements and the requirements of section 501(c)(3), the organization is organized and operated such that the organization (1) does not solicit contributions from consumers during the initial counseling process or while the consumer is receiving services from the organization and (2) the aggregate revenues of the organization that are from payments of creditors of consumers of the organization and that are attributable to debt management plan services do not exceed the applicable percentage of the total revenues of the organization. For credit counseling organizations in existence on the date of enactment, the

⁴³⁵ The requirements described in paragraphs 4, 5, and 6 above address core issues that are related to tax-exempt status and that have proved to be problematic in the credit counseling industry--the provision of services and waiver of fees without regard to ability to pay, the establishment of a reasonable fee policy, and the presence of independent board members. No inference is intended through the provision of these specific requirements on credit counseling organizations that similar or more stringent requirements should not be adhered to by other exempt organizations providing fees for services. Rather, the provision affirms the importance of these core issues to the matter of tax exemption, both to credit counseling organizations and to other types of exempt organizations.

⁴³⁶ If a credit counseling organization pays or receives a fee, for example, for using or maintaining a locator service for consumers to find a credit counseling organization, such a fee is not considered a referral.

applicable percentage is 80 percent for the first taxable year of the organization beginning after the date which is one year after the date of enactment, 70 percent for the second such taxable year beginning after such date, 60 percent for the third such taxable year beginning after such date, and 50 percent thereafter. For new credit counseling organizations, the applicable percentage is 50 percent for taxable years beginning after the date of enactment. Satisfaction of the aggregate revenues requirement is not a safe harbor; all other requirements of the provision (and of section 501(c)(3)) pertaining to section 501(c)(3) organizations also must be satisfied. Satisfaction of the aggregate revenues requirement means only that an organization has not automatically failed to be organized or operated consistent with exempt purposes. Compliance with the revenues test does not mean that the organization's debt management plan services activity is at a level that organizationally or operationally is consistent with exempt status. In other words, satisfaction of the aggregate revenues requirement (as a preliminary matter in an exemption application, or on an ongoing operational basis) provides no affirmative evidence that an organization's primary purpose is an exempt purpose, or that the revenues that are subject to the limitation (or debt management plan services revenues more generally) are related to exempt purposes. As described below, whether revenues from such activity are substantially related to exempt purposes depends on the facts and circumstances, that is, satisfaction of the aggregate revenues requirement generally is not relevant for purposes of whether any of an organization's revenues are revenues from an unrelated trade or business. Failure to satisfy the aggregate revenues requirement does not disqualify the organization from recognition of exemption under section 501(c)(4).

Additional requirement for social welfare organizations

Under the provision, a credit counseling organization is described in section 501(c)(4) only if, in addition to satisfying the above requirements applicable to such organizations, the organization notifies the Secretary, in such manner as the Secretary may by regulations prescribe, that it is applying for recognition as a credit counseling organization.

Debt management plan services treated as an unrelated trade or business

Under the provision, debt management plan services are treated as an unrelated trade or business for purposes of the tax on income from an unrelated trade or business to the extent such services are provided by an organization that is not a credit counseling organization. With respect to the provision of debt management plan services by a credit counseling organization, in order for the income from such services not to be unrelated business income, it is intended that, consistent with current law, the debt management plan service with respect to such income (1) must contribute importantly to the accomplishment of credit counseling services, and (2) must not be conducted on a larger scale than reasonably is necessary for the accomplishment of such services. For example, the provision of debt management plan services would not be substantially related to accomplishing exempt purposes if the organization recommended and enrolled an individual in a debt management plan only after determining whether the individual satisfied the financial criteria established by the creditors for such plan, without (1) considering whether it was an appropriate action in light of the individual's particular needs and objectives, (2) discussing the disadvantages of a debt management plan with the consumer, and (3) presenting other possible options to such consumer.

Definitions

Credit counseling services

Credit counseling services are (a) the provision of educational information to the general public on budgeting, personal finance, financial literacy, saving and spending practices, and the sound use of consumer credit; (b) the assisting of individuals and families with financial problems by providing them with counseling; or (c) any combination of such activities.

Debt management plan services

Debt management plan services are services related to the repayment, consolidation, or restructuring of a consumer's debt, and includes the negotiation with creditors of lower interest rates, the waiver or reduction of fees, and the marketing and processing of debt management plans.

Effective Date

In general, the provision applies to taxable years beginning after the date of enactment. For a credit counseling organization that is described in section 501(c)(3) or 501(c)(4) on the date of enactment, the provision is effective for taxable years beginning after the date that is one year after the date of enactment.

11. Expand the base of the tax on private foundation net investment income (sec. 4940 of the Code)

Present Law

In general

Under section 4940(a) of the Code, private foundations that are recognized as exempt from Federal income tax under section 501(a) of the Code are subject to a two-percent excise tax on their net investment income. Private foundations that are not exempt from tax, such as certain charitable trusts,⁴³⁷ also are subject to an excise tax under section 4940(b) based on net investment income and unrelated business income. The two-percent rate of tax is reduced to one-percent if certain requirements are met in a taxable year.⁴³⁸ Unlike certain other excise taxes imposed on private foundations, the tax based on investment income does not result from a violation of substantive law by the private foundation; it is solely an excise tax.

The tax on taxable private foundations under section 4940(b) is equal to the excess of the sum of the excise tax that would have been imposed under section 4940(a) if the foundation were tax exempt and the amount of the unrelated business income tax that would have been imposed if

⁴³⁷ See sec. 4947(a)(1).

⁴³⁸ Sec. 4940(e).

the foundation were tax exempt, over the income tax imposed on the foundation under subtitle A of the Code.

Net investment income

Internal Revenue Code

In general, net investment income is defined as the amount by which the sum of gross investment income and capital gain net income exceeds the deductions relating to the production of gross investment income.⁴³⁹

Gross investment income is the gross amount of income from interest, dividends, rents, payments with respect to securities loans, and royalties. Gross investment income does not include any income that is included in computing a foundation's unrelated business taxable income.⁴⁴⁰

Capital gain net income takes into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties, and property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax). Losses from sales or other dispositions of property are allowed only to the extent of gains from such sales or other dispositions, and no capital loss carryovers are allowed.⁴⁴¹

Treasury Regulations and case law

The Treasury regulations elaborate on the Code definition of net investment income. The regulations cite items of investment income listed in the Code, and in addition clarify that net investment income includes interest, dividends, rents, and royalties derived from all sources, including from assets devoted to charitable activities. For example, interest received on a student loan is includible in the gross investment income of a foundation making the loan.⁴⁴²

The regulations further provide that gross investment income includes certain items of investment income that are described in the unrelated business income tax regulations.⁴⁴³ Such additional items include payments with respect to securities loans (an item added to the Code in

⁴³⁹ Sec. 4940(c)(1). Net investment income also is determined by applying section 103 (generally providing an exclusion for interest on certain State and local bonds) and section 265 (generally disallowing the deduction for interest and certain other expenses with respect to tax-exempt income). Sec. 4940(c)(5).

⁴⁴⁰ Sec. 4940(c)(2).

⁴⁴¹ Sec. 4940(c)(4).

⁴⁴² Treas. Reg. sec. 53.4940-1(d)(1).

⁴⁴³ *Id.*

1978), annuities, income from notional principal contracts, and other substantially similar income from ordinary and routine investments to the extent determined by the Commissioner.⁴⁴⁴ These latter three categories of income are not enumerated as net investment income in the Code.

The Treasury regulations also elaborate on the Code definition of capital gain net income. The regulations provide that the only capital gains and losses that are taken into account are (1) gains and losses from the sale or other disposition of property held by a private foundation for investment purposes (other than program related investments), and (2) property used for the production of income included in computing the unrelated business income tax (except to the extent the gain or loss is taken into account for purposes of such tax).

This definition of capital gain net income builds on the definition provided in the Code by providing an exception for gain and loss from program related investments and by stating, in addition, that “gains and losses from the sale or other disposition of property used for the exempt purposes of the private foundation are excluded.”⁴⁴⁵ As an example, the regulations provide that gain or loss on the sale of buildings used for the foundation’s exempt activities are not taken into account for purposes of the section 4940 tax. If a foundation uses exempt income for exempt purposes and (other than incidentally) for investment purposes, then the portion of the gain or loss received upon sale or other disposition that is allocable to the investment use is taken into account for purposes of the tax.

The regulations further provide that “property shall be treated as held for investment purposes even though such property is disposed of by the foundation immediately upon its receipt, if it is property of a type which generally produces interest, dividends, rents, royalties, or capital gains through appreciation (for example, rental real estate, stock, bonds, mineral interest, mortgages, and securities).”⁴⁴⁶

This regulation has been challenged in the courts. The regulation says that property is treated as held for investment purposes if it is of a type that “generally produces” certain types of income. By contrast, the Code provides that the property be “used” to produce such income. In *Zemurray Foundation v. United States*, 687 F.2d 97 (5th Cir. 1982), the taxpayer foundation challenged the Treasury’s attempt to tax under section 4940 capital gain on the sale of timber property. The taxpayer asserted that the property was not actually used to produce investment income, and that the Treasury Regulation was invalid because the regulation would subject to tax property that is of a type that could generally be used to produce investment income. On this issue, the court upheld the Treasury regulation, reasoning that the regulation’s use of the phrase “generally used,” though permitting taxation “so long as the property sold is usable to produce the applicable types of income, regardless of whether the property is actually used to produce income or not” was not unreasonable or plainly inconsistent with the statute.⁴⁴⁷ However, on

⁴⁴⁴ Treas. Reg. sec. 1.512(b)-1(a)(1).

⁴⁴⁵ Treas. Reg. sec. 53.4940-1(f)(1).

⁴⁴⁶ *Id.*

⁴⁴⁷ *Zemurray Foundation v. United States*, 687 F.2d 97, 100 (5th Cir. 1982).

remand to the district court, the district court concluded that the timber property at issue, though a type of property generally used to produce investment income, was not susceptible for such use.⁴⁴⁸ Thus, the district court concluded that the Treasury could not tax the gain under this portion of the regulation.

The question then turned to the taxpayer's second challenge to the regulation. At issue was the meaning of the regulatory phrase "capital gains through appreciation." The regulation provides that if property is of a type that generally produces capital gains through appreciation, then the gain is subject to tax. The Treasury argued that the timber property at issue, although held by the court not to be property (in this case) susceptible for use to produce interest, dividends, rents, or royalties, still was held by the taxpayer to produce capital gain through appreciation and therefore the gain should be subject to tax under the regulation.

On this issue, the court held for the taxpayer, reasoning that the language of the Code clearly is limited to certain gains and losses, e.g., the court cited the Code language providing that "there shall be taken into account only gains and losses from the sale or other disposition of property used for the production of interest, dividends, rents, and royalties"⁴⁴⁹ The court noted that "capital gains through appreciation" is not enumerated in the statute. The court used as an example a jade figurine held by a foundation. Jade figurines do not generally produce interest, dividends, rents, or royalties, but gain on the sale of such a figurine would be taxable under the "capital gains through appreciation" standard, yet such standard does not appear in the statute. After *Zemurray*, the Treasury generally conceded this issue.⁴⁵⁰

With respect to capital losses, the Code provides that carryovers are not permitted, whereas the regulations state that neither carryovers nor carrybacks are permitted.⁴⁵¹

Application of *Zemurray* to the Code and the regulations

Applying the *Zemurray* case to the Code and regulations results in a general principle for purposes of present law: private foundations are subject to tax under section 4940 only on the items of income and only on gains and losses specifically enumerated therein. Under this principle, private foundations generally are not subject to the section 4940 tax on other substantially similar types of income from ordinary and routine investments, notwithstanding Treasury regulations to the contrary. In addition, the regulations provide that gain or loss from the sale or other disposition of assets used for exempt purposes, with specific reference to program-related investments, is excluded. The Code provides for no such blanket exclusion; thus, under the language of the Code and the reasoning of *Zemurray*, if a foundation provided

⁴⁴⁸ *Zemurray Foundation v. United States*, 53 A.F.T.R. 2d (RIA) 842 (E. D. La. 1983).

⁴⁴⁹ *Zemurray Foundation v. United States*, 755 F.2d 404 (5th Cir. 1985), 413 (citing Code sec. 4940(c)(4)(A)).

⁴⁵⁰ G.C.M. 39538 (July 23, 1986).

⁴⁵¹ Treas. Reg. sec. 53.4940-1(f)(3).

office space at below market rent to a charitable organization for use in the organization's exempt purposes, gain on the sale of the building by the foundation should be subject to the section 4940 tax despite the Treasury regulations.⁴⁵²

In addition, under the logic of Zemurray, capital loss carrybacks arguably are permitted, notwithstanding Treasury regulations to the contrary, because the Code mentions only a bar on use of carryovers and says nothing about carrybacks.

Explanation of Provision

The provision amends the definition of gross investment income (including for purposes of capital gain net income) to include items of income that are similar to the items presently enumerated in the Code. Such similar items include income from notional principal contracts, annuities, and other substantially similar income from ordinary and routine investments, and, with respect to capital gain net income, capital gains from appreciation, including capital gains and losses from the sale or other disposition of assets used to further an exempt purpose.

Certain gains and losses are not taken into account in determining capital gain net income. Specifically, under the provision, no gain or loss shall be taken into account with respect to any portion of property used for a period of not less than one year for a purpose or function constituting the basis of the private foundation's exemption, if the entire property is exchanged immediately following such period solely for property of like kind which is to be used primarily for a purpose or function constituting the basis for such foundation's exemption. Rules similar to the rules of section 1031 (relating to exchange of property held for productive use or investment) apply, including, but not limited to, the exceptions of section 1031(a)(2) and the rule of section 1031(a)(3) regarding completion of the exchange within 180 days.

The provision provides that there are no carrybacks of losses from sales or other dispositions of property.

Effective Date

The provision is effective for taxable years beginning after the date of enactment.

12. Definition of convention or association of churches (sec. 7701 of the Code)

Present Law

Under present law, an organization that qualifies as a "convention or association of churches" (within the meaning of sec. 170(b)(1)(A)(i)) is not required to file an annual return,⁴⁵³ is subject to the church tax inquiry and church tax examination provisions applicable to

⁴⁵² See also the example in Treas. Reg. sec. 53.4940-1(f)(1).

⁴⁵³ Sec. 6033(a)(2)(A)(i).

organizations claiming to be a church,⁴⁵⁴ and is subject to certain other provisions generally applicable to churches.⁴⁵⁵ The Internal Revenue Code does not define the term “convention or association of churches.”

Explanation of Provision

The provision provides that an organization that otherwise is a convention or association of churches does not fail to so qualify merely because the membership of the organization includes individuals as well as churches, or because individuals have voting rights in the organization.

Effective Date

The provision is effective on the date of enactment.

13. Notification requirement for exempt entities not currently required to file an annual information return (secs. 6033, 6652, and 7428 of the Code)

Present Law

Under present law, the requirement that an exempt organization file an annual information return does not apply to several categories of exempt organizations. Organizations excepted from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than \$25,000.⁴⁵⁶ Also exempt from the requirement are churches, their integrated auxiliaries, and conventions or associations of churches; the exclusively religious activities of any religious order; section 501(c)(1)

⁴⁵⁴ Sec. 7611(h)(1)(B).

⁴⁵⁵ *See, e.g.*, Sec. 402(g)(8)(B) (limitation on elective deferrals); sec. 403(b)(9)(B) (definition of retirement income account); sec. 410(d) (election to have participation, vesting, funding, and certain other provisions apply to church plans); sec. 414(e) (definition of church plan); sec. 415(c)(7) (certain contributions by church plans); sec. 501(h)(5) (disqualification of certain organizations from making the sec. 501(h) election regarding lobbying expenditure limits); sec. 501(m)(3) (definition of commercial-type insurance); sec. 508(c)(1)(A) (exception from requirement to file application seeking recognition of exempt status); sec. 512(b)(12) (allowance of up to \$1,000 deduction for purposes of determining unrelated business taxable income); sec. 514(b)(3)(E) (definition of debt-financed property); sec. 3121(w)(3)(A) (election regarding exemption from social security taxes); sec. 3309(b)(1) (application of federal unemployment tax provisions to services performed in the employ of certain organizations); sec. 6043(b)(1) (requirement to file a return upon liquidation or dissolution of the organization); and sec. 7702(j)(3)(A) (treatment of certain death benefit plans as life insurance).

⁴⁵⁶ Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a \$5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to \$25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

instrumentalities of the United States; section 501(c)(21) trusts; an interchurch organization of local units of a church; certain mission societies; certain church-affiliated elementary and high schools; certain State institutions whose income is excluded from gross income under section 115; certain governmental units and affiliates of governmental units; and other organizations that the IRS has relieved from the filing requirement pursuant to its statutory discretionary authority.

Explanation of Provision

The provision requires organizations that are excused from filing an information return by reason of normally having gross receipts below a certain specified amount (generally, under \$25,000) to furnish to the Secretary annually, in electronic form, the legal name of the organization, any name under which the organization operates or does business, the organization's mailing address and Internet web site address (if any), the organization's taxpayer identification number, the name and address of a principal officer, and evidence of the organization's continuing basis for its exemption from the generally applicable information return filing requirements. Upon such organization's termination of existence, the organization is required to furnish notice of such termination.

The provision provides that if an organization fails to provide the required notice for three consecutive years, the organization's tax-exempt status is revoked. In addition, if an organization that is required to file an annual information return under section 6033(a) (Form 990) fails to file such an information return for three consecutive years, the organization's tax-exempt status is revoked. If an organization fails to meet its filing obligation to the IRS for three consecutive years in cases where the organization is subject to the information return filing requirement in one or more years during a three-year period and also is subject to the notice requirement for one or more years during the same three-year period, the organization's tax-exempt status is revoked.

A revocation under the provision is effective from the date that the Secretary determines was the last day the organization could have timely filed the third required information return or notice. To again be recognized as tax-exempt, the organization must apply to the Secretary for recognition of tax-exemption, irrespective of whether the organization was required to make an application for recognition of tax-exemption in order to gain tax-exemption originally.

If, upon application for tax-exempt status after a revocation under the provision, the organization shows to the satisfaction of the Secretary reasonable cause for failing to file the required annual notices or returns, the organization's tax-exempt status may, in the discretion of the Secretary, be reinstated retroactive to the date of revocation. An organization may not challenge under the Code's declaratory judgment procedures (section 7428) a revocation of tax-exemption made pursuant to the provision.

There is no monetary penalty for failure to file the notice under the provision. Like other information returns, the notices are subject to the public disclosure and inspection rules generally applicable to exempt organizations. The provision does not affect an organization's obligation under present law to file required information returns or existing penalties for failure to file such returns.

The Secretary is required to notify every organization that is subject to the notice filing requirement of the new filing obligation in a timely manner. Notification by the Secretary shall be by mail, in the case of any organization the identity and address of which is included in the list of exempt organizations maintained by the Secretary, and by Internet or other means of outreach, in the case of any other organization. In addition, the Secretary is required to publicize in a timely manner in appropriate forms and instructions and other means of outreach the new penalty imposed for consecutive failures to file the information return.

The Secretary is authorized to publish a list of organizations whose exempt status is revoked under the provision.

Effective Date

The provision is effective for notices and returns with respect to annual periods beginning after 2006.

14. Disclosure to State officials relating to section 501(c) organizations (secs. 6103, 6104, 7213, 7213A, and 7431 of the Code)

Present Law

In the case of organizations that are described in section 501(c)(3) and exempt from tax under section 501(a) or that have applied for exemption as an organization so described, present law (sec. 6104(c)) requires the Secretary to notify the appropriate State officer of (1) a refusal to recognize such organization as an organization described in section 501(c)(3), (2) a revocation of a section 501(c)(3) organization's tax-exempt status, and (3) the mailing of a notice of deficiency for any tax imposed under section 507, chapter 41, or chapter 42.⁴⁵⁷ In addition, at the request of such appropriate State officer, the Secretary is required to make available for inspection and copying, such returns, filed statements, records, reports, and other information relating to the above-described disclosures, as are relevant to any State law determination. An appropriate State officer is the State attorney general, State tax officer, or any State official charged with overseeing organizations of the type described in section 501(c)(3).

In general, returns and return information (as such terms are defined in section 6103(b)) are confidential and may not be disclosed or inspected unless expressly provided by law.⁴⁵⁸ Present law requires the Secretary to keep records of disclosures and requests for inspection⁴⁵⁹

⁴⁵⁷ The applicable taxes include the termination tax on private foundations; taxes on public charities for certain excess lobbying expenses; taxes on a private foundation's net investment income, self-dealing activities, undistributed income, excess business holdings, investments that jeopardize charitable purposes, and taxable expenditures (some of these taxes also apply to certain non-exempt trusts); taxes on the political expenditures and excess benefit transactions of section 501(c)(3) organizations; and certain taxes on black lung benefit trusts and foreign organizations.

⁴⁵⁸ Sec. 6103(a).

⁴⁵⁹ Sec. 6103(p)(3).

and requires that persons authorized to receive returns and return information maintain various safeguards to protect such information against unauthorized disclosure.⁴⁶⁰ Willful unauthorized disclosure or inspection of returns or return information is subject to a fine and/or imprisonment.⁴⁶¹ The knowing or negligent unauthorized inspection or disclosure of returns or return information gives the taxpayer a right to bring a civil suit.⁴⁶² Such present-law protections against unauthorized disclosure or inspection of returns and return information do not apply to the disclosures or inspections, described above, that are authorized by section 6104(c).

Explanation of Provision

The provision provides that upon written request by an appropriate State officer, the Secretary may disclose: (1) a notice of proposed refusal to recognize an organization as a section 501(c)(3) organization; (2) a notice of proposed revocation of tax-exemption of a section 501(c)(3) organization; (3) the issuance of a proposed deficiency of tax imposed under section 507, chapter 41, or chapter 42; (4) the names, addresses, and taxpayer identification numbers of organizations that have applied for recognition as section 501(c)(3) organizations; and (5) returns and return information of organizations with respect to which information has been disclosed under (1) through (4) above.⁴⁶³ Disclosure or inspection is permitted for the purpose of, and only to the extent necessary in, the administration of State laws regulating section 501(c)(3) organizations, such as laws regulating tax-exempt status, charitable trusts, charitable solicitation, and fraud. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. The Secretary also is permitted to disclose or open to inspection the returns and return information of an organization that is recognized as tax-exempt under section 501(c)(3), or that has applied for such recognition, to an appropriate State officer if the Secretary determines that disclosure or inspection may constitute evidence of noncompliance under the laws within the jurisdiction of the appropriate State officer. For this purpose, appropriate State officer means the State attorney general, the State tax officer, or any other State official charged with overseeing organizations of the type described in section 501(c)(3).

In addition, the provision provides that upon the written request by an appropriate State officer, the Secretary may make available for inspection or disclosure returns and return information of an organization described in section 501(c) (other than section 501(c)(1) or section 501(c)(3)). Such returns and return information are available for inspection or disclosure only for the purpose of, and to the extent necessary in, the administration of State laws regulating the solicitation or administration of the charitable funds or charitable assets of such

⁴⁶⁰ Sec. 6103(p)(4).

⁴⁶¹ Secs. 7213 and 7213A.

⁴⁶² Sec. 7431.

⁴⁶³ Such returns and return information also may be open to inspection by an appropriate State officer.

organizations. Such disclosure or inspection may be made only to or by an appropriate State officer or to an officer or employee of the State who is designated by the appropriate State officer, and may not be made by or to a contractor or agent. For this purpose, appropriate State officer means the State attorney general, the State tax officer, and the head of an agency designated by the State attorney general as having primary responsibility for overseeing the solicitation of funds for charitable purposes of such organizations.

In addition, the provision provides that any returns and return information disclosed under section 6104(c) may be disclosed in civil administrative and civil judicial proceedings pertaining to the enforcement of State laws regulating the applicable tax-exempt organization in a manner prescribed by the Secretary. Returns and return information are not to be disclosed under section 6104(c), or in such an administrative or judicial proceeding, to the extent that the Secretary determines that such disclosure would seriously impair Federal tax administration. The provision makes disclosures of returns and return information under section 6104(c) subject to the disclosure, recordkeeping, and safeguard provisions of section 6103, including through requirements that the Secretary maintain a permanent system of records of requests for disclosure (sec. 6103(p)(3)) and that the appropriate State officer maintain various safeguards that protect against unauthorized disclosure (sec. 6103(p)(4)). The provision provides that the willful unauthorized disclosure of returns or return information described in section 6104(c) is a felony subject to a fine of up to \$5,000 and/or imprisonment of up to five years (sec. 7213(a)(2)), the willful unauthorized inspection of returns or return information described in section 6104(c) is subject to a fine of up to \$1,000 and/or imprisonment of up to one year (sec. 7213A), and provides the taxpayer the right to bring a civil action for damages in the case of knowing or negligent unauthorized disclosure or inspection of such information (sec. 7431(a)(2)).

Effective Date

The provision is effective on the date of enactment but does not apply to requests made before such date.

15. Require that unrelated business income tax returns of section 501(c)(3) organizations be made publicly available (sec. 6104 of the Code)

Present Law

In general, an organization described in section 501(c) or (d) is required to make available for public inspection a copy of its annual information return (Form 990) and exemption application materials.⁴⁶⁴ A penalty may be imposed on any person who does not make an organization's annual returns or exemption application materials available for public inspection. The penalty amount is \$20 for each day during which a failure occurs. If more than one person fails to comply, each person is jointly and severally liable for the full amount of the penalty. The maximum penalty that may be imposed on all persons for any one annual return is \$10,000. There is no maximum penalty amount for failing to make exemption application materials

⁴⁶⁴ Sec. 6104(d).

available for public inspection. Any person who willfully fails to comply with the public inspection requirements is subject to an additional penalty of \$5,000.⁴⁶⁵

These requirements do not apply to an organization's annual return for unrelated business income tax (generally Form 990-T).⁴⁶⁶

Explanation of Provision

The provision extends the present-law public inspection and disclosure requirements and penalties applicable to the Form 990 to the unrelated business income tax return (Form 990-T) of organizations described in section 501(c)(3). The provision provides that certain information may be withheld by the organization from public disclosure and inspection if public availability would adversely affect the organization, similar to the information that may be withheld under present law with respect to applications for tax exemption and the Form 990 (e.g., information relating to a trade secret, patent, process, style of work, or apparatus of the organization, if the Secretary determines that public disclosure of such information would adversely affect the organization).

Effective Date

The provision is effective for returns filed after the date of enactment.

16. Treasury study on donor advised funds and supporting organizations

Present Law

Donor advised funds

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

⁴⁶⁵ Sec. 6685.

⁴⁶⁶ Treas. Reg. sec. 301.6104(d)-1(b)(4)(ii).

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as “commercial” donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including “commercial” donor advised funds, as section 501(c)(3) public charities. The term “donor advised fund” is not defined in statute or regulations.

Supporting organizations

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.⁴⁶⁷ To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”⁴⁶⁸ (the “organizational and operational tests”);⁴⁶⁹ (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);⁴⁷⁰ and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).⁴⁷¹

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).⁴⁷²

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies,

⁴⁶⁷ Sec. 509(a)(3).

⁴⁶⁸ In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

⁴⁶⁹ Sec. 509(a)(3)(A).

⁴⁷⁰ Sec. 509(a)(3)(B).

⁴⁷¹ Sec. 509(a)(3)(C).

⁴⁷² Treas. Reg. sec. 1.509(a)-4(f)(2).

programs, and activities of the supporting organization.⁴⁷³ The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.⁴⁷⁴

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.⁴⁷⁵ An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.⁴⁷⁶

Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”⁴⁷⁷ In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly

⁴⁷³ Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

⁴⁷⁴ Id.

⁴⁷⁵ Treas. Reg. sec. 1.509(a)-4(h)(1).

⁴⁷⁶ Treas. Reg. sec. 1.509(a)-4(h)(2).

⁴⁷⁷ Treas. Reg. sec. 1.509(a)-4(i)(1).

supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.⁴⁷⁸ Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;⁴⁷⁹ (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);⁴⁸⁰ and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.⁴⁸¹

Explanation of Provision

Elsewhere in the bill, provision is made for new rules with respect to donor advised funds and supporting organizations. Many issues arise under current law with respect to such organizations, some of which are addressed by the bill and some of which would benefit from additional study. The provision provides that the Secretary of the Treasury shall undertake a study on the organization and operation of donor advised funds (as defined in section 4966(d)(2)) and of supporting organizations (organizations described in section 509(a)(3)). The study shall specifically consider (1) whether the amount and availability of the income, gift, or estate tax charitable deductions allowed for charitable contributions to sponsoring organizations (as defined in section 4966(d)(1)) of donor advised funds or to organizations described in section 509(a)(3) is appropriate in consideration of (i) the use of contributed assets (including the type, extent, and timing of such use) or (ii) the use of the assets of such organizations for the benefit of the person making the charitable contribution (or a person related to such person), (2) whether donor advised funds should be required to distribute for charitable purposes a specified amount (whether based on the income or assets of the fund) in order to ensure that the sponsoring organization with respect to the fund is operating consistent with the purposes or functions constituting the basis for its exemption under section 501 or its status as an organization

⁴⁷⁸ Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

⁴⁷⁹ For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

⁴⁸⁰ Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

⁴⁸¹ Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

described in section 509(a), (3) whether the retention by donors to donor advised funds or supporting organizations of rights or privileges with respect to amounts transferred to such organizations (including advisory rights or privileges with respect to the making of grants or the investment of assets) is consistent with the treatment of such transfers as completed gifts that qualify for an income, gift, or estate tax charitable deduction, and (4) whether any of the issues addressed above also raise issues with respect to other forms of charities or charitable donations.

Not later than one year after the date of enactment of this Act, the Secretary shall submit a report on the study, comment on any actions (audits, guidance, regulations, etc.) taken by the Secretary with respect to the issues discussed in the study, and make recommendations to the Committee on Finance of the Senate and the Committee on Ways and Means of the House of Representatives.

Effective Date

The provision is effective on the date of enactment.

17. Improve accountability of donor advised funds (new secs. 4966 and 4967 of the Code)

Present Law

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.⁴⁸² In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;⁴⁸³ (3) the organization may not be operated primarily to conduct an unrelated trade or business;⁴⁸⁴ (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

⁴⁸² Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

⁴⁸³ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

⁴⁸⁴ Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

Classification of section 501(c)(3) organizations

Section 501(c)(3) organizations are classified either as “public charities” or “private foundations.”⁴⁸⁵ Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.⁴⁸⁶ For example, the Code imposes excise taxes on acts of “self-dealing” between disqualified persons (generally, an enumerated class of foundation insiders⁴⁸⁷) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.⁴⁸⁸ In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization’s exempt purposes, including reasonable and necessary administrative expenses.⁴⁸⁹ Certain expenditures of private foundations are also subject to tax.⁴⁹⁰ In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt

⁴⁸⁵ Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

⁴⁸⁶ Secs. 4940 - 4945.

⁴⁸⁷ See sec. 4946(a).

⁴⁸⁸ Sec. 4941.

⁴⁸⁹ Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization’s exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

⁴⁹⁰ Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

operating foundation unless the foundation exercises expenditure responsibility⁴⁹¹ with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may also apply in the event a private foundation holds certain business interests (“excess business holdings”)⁴⁹² or makes an investment that jeopardizes the foundation’s exempt purposes.⁴⁹³

Supporting organizations

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.⁴⁹⁴ To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”⁴⁹⁵ (the “organizational and operational tests”);⁴⁹⁶ (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);⁴⁹⁷ and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).⁴⁹⁸

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).⁴⁹⁹

⁴⁹¹ In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

⁴⁹² Sec. 4943.

⁴⁹³ Sec. 4944.

⁴⁹⁴ Sec. 509(a)(3).

⁴⁹⁵ In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

⁴⁹⁶ Sec. 509(a)(3)(A).

⁴⁹⁷ Sec. 509(a)(3)(B).

⁴⁹⁸ Sec. 509(a)(3)(C).

⁴⁹⁹ Treas. Reg. sec. 1.509(a)-4(f)(2).

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.⁵⁰⁰ The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.⁵⁰¹

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.⁵⁰² An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.⁵⁰³

Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”⁵⁰⁴ In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such

⁵⁰⁰ Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

⁵⁰¹ Id.

⁵⁰² Treas. Reg. sec. 1.509(a)-4(h)(1).

⁵⁰³ Treas. Reg. sec. 1.509(a)-4(h)(2).

⁵⁰⁴ Treas. Reg. sec. 1.509(a)-4(i)(1).

publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides.

There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.⁵⁰⁵ Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;⁵⁰⁶ (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);⁵⁰⁷ and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the attentiveness requirement.⁵⁰⁸

Charitable contributions

Contributions to organizations described in section 501(c)(3) are deductible, subject to certain limitations, as an itemized deduction from Federal income taxes.⁵⁰⁹ Such contributions also generally are deductible for estate and gift tax purposes.⁵¹⁰ However, if the taxpayer retains control over the assets transferred to charity, the transfer may not qualify as a completed gift for purposes of claiming an income, estate, or gift tax deduction.

Public charities enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to

⁵⁰⁵ Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

⁵⁰⁶ For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

⁵⁰⁷ Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

⁵⁰⁸ Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

⁵⁰⁹ Sec. 170.

⁵¹⁰ Secs. 2055 and 2522.

a private foundation generally are deductible only to the extent of the donor's cost basis.⁵¹¹ In contrast, contributions to public charities generally are deductible in an amount equal to the property's fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization's exempt purpose. In addition, under present law, a taxpayer's deductible contributions generally are limited to specified percentages of the taxpayer's contribution base, which generally is the taxpayer's adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor's contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).⁵¹²

In general, taxpayers who make contributions and claim a charitable deduction must satisfy recordkeeping and substantiation requirements.⁵¹³ The requirements vary depending on the type and value of property contributed. A deduction generally may be denied if the donor fails to satisfy applicable recordkeeping or substantiation requirements.

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.⁵¹⁴ An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.⁵¹⁵ Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

⁵¹¹ A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

⁵¹² Sec. 170(b).

⁵¹³ Sec. 170(f)(8).

⁵¹⁴ Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

⁵¹⁵ Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Community foundations

Community foundations generally are broadly supported section 501(c)(3) public charities that make grants to other charitable organizations located within a community foundation's particular geographic area. Donors sometimes make contributions to a community foundation through transfers to a separate trust or fund, the assets of which are held and managed by a bank or investment company.

Certain community foundations are subject to special rules that permit them to treat the separate funds or trusts maintained by the community foundation as a single entity for tax purposes. This "single entity" status allows the community foundation to be classified as a public charity. One of the requirements that community foundations must meet is that funds maintained by the community foundation may not be subject by the donor to any material restrictions or conditions. The prohibition against material restrictions or conditions is designed to prevent a donor from encumbering a fund in a manner that prevents the community foundation from freely distributing the assets and income from it in furtherance of the community foundation's charitable purposes. Under Treasury regulations, whether a particular restriction or condition placed by the donor on the transfer of assets is material must be determined from all of the facts and circumstances of the transfer. The regulations set out some of the more significant facts and circumstances to be considered in making a determination, including: (1) whether the transferee public charity is the fee owner of the assets received; (2) whether the assets are held and administered by the public charity in a manner consistent with its own exempt purposes; (3) whether the governing body of the public charity has the ultimate authority and control over the assets and the income derived from them; and (4) whether the governing body of the public charity is independent from the donor. The regulations provide several non-adverse factors for determining whether a particular restriction or condition placed by the donor on the transfer of assets is material. In addition, the regulations list numerous factors and subfactors that indicate that the community foundation is prevented from freely and effectively employing the donated assets and the income thereon.

Donor advised funds

Some charitable organizations (including community foundations) establish accounts to which donors may contribute and thereafter provide nonbinding advice or recommendations with regard to distributions from the fund or the investment of assets in the fund. Such accounts are commonly referred to as "donor advised funds." Donors who make contributions to charities for maintenance in a donor advised fund generally claim a charitable contribution deduction at the

time of the contribution. Although sponsoring charities frequently permit donors (or other persons appointed by donors) to provide nonbinding recommendations concerning the distribution or investment of assets in a donor advised fund, sponsoring charities generally must have legal ownership and control of such assets following the contribution. If the sponsoring charity does not have such control (or permits a donor to exercise control over amounts contributed), the donor's contributions may not qualify for a charitable deduction, and, in the case of a community foundation, the contribution may be treated as being subject to a material restriction or condition by the donor.

In recent years, a number of financial institutions have formed charitable corporations for the principal purpose of offering donor advised funds, sometimes referred to as "commercial" donor advised funds. In addition, some established charities have begun operating donor advised funds in addition to their primary activities. The IRS has recognized several organizations that sponsor donor advised funds, including "commercial" donor advised funds, as section 501(c)(3) public charities. The term "donor advised fund" is not defined in statute or regulations.

Under the Katrina Emergency Tax Relief Act of 2005, certain of the above-described percent limitations on contributions to public charities are temporarily suspended for purposes of certain "qualified contributions" to public charities. Under the Act, qualified contributions do not include a contribution if the contribution is for establishment of a new, or maintenance in an existing, segregated fund or account with respect to which the donor (or any person appointed or designated by such donor) has, or reasonably expects to have, advisory privileges with respect to distributions or investments by reason of the donor's status as a donor.

Excess business holdings of private foundations

Private foundations are subject to tax on excess business holdings.⁵¹⁶ In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock"). Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.⁵¹⁷ This five-year period may be extended an additional five years in limited circumstances.⁵¹⁸ The excess business holdings rules do not apply to

⁵¹⁶ Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

⁵¹⁷ Sec. 4943(c)(6).

⁵¹⁸ Sec. 4943(c)(7).

holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.⁵¹⁹

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Explanation of Provision

Definition of a donor advised fund

General rule

In general, the provision defines a "donor advised fund" as a fund or account that is: (1) separately identified by reference to contributions of a donor or donors (2) owned and controlled by a sponsoring organization and (3) with respect to which a donor (or any person appointed or designated by such donor (a "donor advisor") has, or reasonably expects to have, advisory privileges with respect to the distribution or investment of amounts held in the separately identified fund or account by reason of the donor's status as a donor. All three prongs of the definition must be met in order for a fund or account to be treated as a donor advised fund.

The provision defines a "sponsoring organization" as an organization that: (1) is described in section 170(c)⁵²⁰ (other than a governmental entity described in section 170(c)(1), and without regard to any requirement that the organization be organized in the United States⁵²¹); (2) is not a private foundation (as defined in section 509(a)); and (3) maintains one or more donor advised funds.

The first prong of the definition requires that a donor advised fund be separately identified by reference to contributions of a donor or donors. A distinct fund or account of a sponsoring organization does not meet this prong of the definition unless the fund or account refers to contributions of a donor or donors, such as by naming the fund after a donor, or by treating a fund on the books of the sponsoring organization as attributable to funds contributed by a specific donor or donors. Although a sponsoring organization's general fund is a "fund or account," such fund will not, as a general matter, be treated as a donor advised fund because the general funds of an organization typically are not separately identified by reference to contributions of a specific donor or donors; rather contributions are pooled anonymously within the general fund. Similarly, a fund or account of a sponsoring organization that is distinct from the organization's general fund and that pools contributions of multiple donors generally will not

⁵¹⁹ Sec. 4943(d)(3).

⁵²⁰ Section 170(c) describes organizations to which charitable contributions that are deductible for income tax purposes can be made.

⁵²¹ See sec. 170(c)(2)(A).

meet the first prong of the definition unless the contributions of specific donors are in some manner tracked and accounted for within the fund. Accordingly, if a sponsoring organization establishes a fund dedicated to the relief of poverty within a specific community, or a scholarship fund, and the fund attracts contributions from several donors but does not separately identify or refer to contributions of a donor or donors, the fund is not a donor advised fund even if a donor has advisory privileges with respect to the fund. However, a fund or account may not avoid treatment as a donor advised fund even though there is no formal recognition of such separate contributions on the books of the sponsoring organization if the fund or account operates as if contributions of a donor or donors are separately identified. The Secretary has the authority to look to the substance of an arrangement, and not merely its form. In addition, a fund or account may be treated as identified by reference to contributions of a donor or donors if the reference is to persons related to a donor. For example, if a husband made contributions to a fund or account that in turn is named after the husband's wife, the fund is treated as being separately identified by reference to contributions of a donor.

The second prong of the definition provides that the fund be owned and controlled by a sponsoring organization. To the extent that a donor or person other than the sponsoring organization owns or controls amounts deposited to a sponsoring organization, a fund or account is not a donor advised fund. (In cases where a donor retains control of an amount provided to a sponsoring organization, there may not be a completed gift for purposes of the charitable contribution deduction.)

The third prong of the definition provides that with respect to a fund or account of a sponsoring organization, a donor or donor advisor has or reasonably expects to have advisory privileges with respect to the distribution or investment of amounts held in the fund or account by reason of a donor's status as a donor. Advisory privileges are distinct from a legal right or obligation. For example, if a donor executes a gift agreement with a sponsoring organization that specifies certain enforceable rights of the donor with respect to a gift, the donor will not be treated as having "advisory privileges" due to such enforceable rights for purposes of the donor advised fund definition.

The presence of an advisory privilege may be evident through a written document that describes an arrangement between the donor or donor advisor and the sponsoring organization whereby a donor or donor advisor may provide advice to the sponsoring organization about the investment or distribution of amounts held by a sponsoring organization, even if such privileges are not exercised. The presence of an advisory privilege also may be evident through the conduct of a donor or donor advisor and the sponsoring organization. For example, even in the absence of a writing, if a donor regularly provides advice to a sponsoring organization and the sponsoring organization regularly considers such advice, the donor has advisory privileges under the provision. Even if advisory privileges do not exist at the time of a contribution, later acts by the donor (through the provision of advice) and by the sponsoring organization (through the regular consideration of advice) may establish advisory privileges subsequent to the time of the contribution. For example, if a past donor of \$100,000 telephones a sponsoring organization and states that he would like the sponsoring organization to distribute \$10,000 to an organization described in section 170(b)(1)(A), although the mere act of providing advice does not establish an advisory privilege, if the sponsoring organization distributed the \$10,000 to the organization specified by the donor in consideration of the donor's advice, and reinforced the donor in some

manner that future advice similarly would be considered, advisory privileges (or the reasonable expectation thereof) might be established. However, the mere provision of advice by a donor or donor advisor does not mean the donor or donor advisor has advisory privileges. For example, a donor's singular belief that he or she has advisory privileges with respect to the contribution does not establish an advisory privilege – there must be some reciprocity on the part of the sponsoring organization.

A person reasonably expects to have advisory privileges if both the donor or donor advisor and the sponsoring organization have reason to believe that the donor or donor advisor will provide advice and that the sponsoring organization generally will consider it. Thus, a person reasonably may expect to have advisory privileges even in the absence of the actual provision of advice. However, a donor's expectation of advisory privileges is not reasonable unless it is reinforced in some manner by the conduct of the sponsoring organization. If, at the time of the contribution, the sponsoring organization had no knowledge that the donor had an expectation of advisory privileges, or no intention of considering any advice provided by the donor, then the donor does not have a reasonable expectation of advisory privileges. Ultimately, the presence or absence of advisory privileges (or a reasonable expectation thereof) depends upon the facts and circumstances, which in turn depend upon the conduct (including any agreement) of both the donor or donor advisor and the sponsoring organization with respect to the making and consideration of advice.

A further requirement of the third prong is that the reasonable expectation of advisory privileges is by reason of the donor's status as a donor. Under this requirement, if a donor's reasonable expectation of advisory privileges is due solely to the donor's service to the organization, for example, by reason of the donor's position as an officer, employee, or director of the sponsoring organization, then the third prong of the definition is not satisfied. For instance, in general, a donor that is a member of the board of directors of the sponsoring organization may provide advice in his or her capacity as a board member with respect to the distribution or investment of amounts in a fund to which the board member contributed. However, if by reason of such donor's contribution to such fund, the donor secured an appointment on a committee of the sponsoring organization that advises how to distribute or invest amounts in such fund, the donor may have a reasonable expectation of advisory privileges, notwithstanding that the donor is an officer, employee, or director of the sponsoring organization.

The third prong of the definition is applicable to a donor or any person appointed or designated by such donor (the donor advisor). For purposes of this prong, a person appointed or designated by a donor advisor is treated as being appointed or designated by a donor. In addition, for purposes of any exception to the definition of a donor advised fund provided under the provision, to the extent a donor recommends to a sponsoring organization the selection of members of a committee that will advise as to distributions or investments of amounts in a fund or account of such sponsoring organization, such members are not treated as appointed or designated by the donor if the recommendation of such members by such donor is based on objective criteria related to the expertise of the member. For example, if a donor recommends that a committee of a sponsoring organization that will provide advice regarding scholarship grants for the advancement of science at local secondary schools should consist of persons who are the heads of the science departments of such schools, then the donor generally would not be

considered to have appointed or designated such persons, i.e., they would not be treated as donor advisors.

Exceptions

A donor advised fund does not include a fund or account that makes distributions only to a single identified organization or governmental entity. For example, an endowment fund owned and controlled by a sponsoring organization that is held exclusively to for the benefit of such sponsoring organization is not a donor advised fund even if the fund is named after its principal donor and such donor has advisory privileges with respect to the distribution of amounts held in the fund to such sponsoring organization. Accordingly, a donor that contributes to a university for purposes of establishing a fund named after the donor that exclusively supports the activities of the university is not a donor advised fund even if the donor has advisory privileges regarding the distribution or investment of amounts in the fund.

A donor advised fund also does not include a fund or account with respect to which a donor or donor advisor provides advice as to which individuals receive grants for travel, study, or other similar purposes, provided that (1) the donor's or donor advisor's advisory privileges are performed exclusively by such donor or donor advisor in such person's capacity as a member of a committee all of the members of which are appointed by the sponsoring organization, (2) no combination of a donor or donor advisor or persons related to such persons, control, directly or indirectly, such committee, and (3) all grants from such fund or account are awarded on an objective and nondiscriminatory basis pursuant to a procedure approved in advance by the board of directors of the sponsoring organization, and such procedure is designed to ensure that all such grants meet the requirements described in paragraphs (1), (2), or (3) of section 4945(g) (concerning grants to individuals by private foundations).

In addition, the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account is advised by a committee not directly or indirectly controlled by a donor, donor advisor, or persons related to a donor or donor advisor. For such purposes, it is intended that indirect control includes the ability to exercise effective control. For example, if a donor, a donor advisor, and an attorney hired by the donor to provide advice regarding the donor's contributions constitute three of the five members of such a committee, the committee would be treated as being controlled indirectly by the donor for purposes of such an exception. Board membership alone does not establish direct or indirect control. In general, under this authority, the Secretary may establish rules regarding committee advised funds generally that, if followed, would result in the fund not being treated as a donor advised fund. The Secretary also may establish rules excepting certain types of committee-advised funds, such as a fund established exclusively for disaster relief, from the donor advised fund definition.

The provision also provides that the Secretary may exempt a fund or account from treatment as a donor advised fund if such fund or account benefits a single identified charitable purpose.

Deductibility of contributions to a sponsoring organization for maintenance in a donor advised fund

Contributions to certain sponsoring organizations for maintenance in a donor advised fund not eligible for a charitable deduction

Under the provision, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income tax purposes if the sponsoring organization is a veterans' organization described in section 170(c)(3), a fraternal society described in section 170(c)(4), or a cemetery company described in section 170(c)(5); for gift tax purposes if the sponsoring organization is a fraternal society described in section 2522(a)(3) or a veterans' organization described in section 2522(a)(4); or for estate tax purposes if the sponsoring organization is a fraternal society described in section 2055(a)(3) or a veterans' organization described in section 2055(a)(4). In addition, contributions to a sponsoring organization for maintenance in a donor advised fund are not eligible for a charitable deduction for income, gift, or estate tax purposes if the sponsoring organization is a Type III supporting organization (other than a functionally integrated Type III supporting organization). A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.⁵²²

Additional substantiation requirements

In addition to satisfying present-law substantiation requirements under section 170(f), a donor must obtain, with respect to each charitable contribution to a sponsoring organization to be maintained in a donor advised fund, a contemporaneous written acknowledgment from the sponsoring organization providing that the sponsoring organization has exclusive legal control over the assets contributed.

Excess business holdings

The excess business holdings rules of section 4943 are applied to donor advised funds. In applying such rules, the term disqualified person means, with respect to a donor advised fund, a donor, donor advisor, a member of the family of a donor or donor advisor, or a 35 percent controlled entity of any such person. Transition rules apply to the present holdings of a donor advised fund similar to those of section 4943(c)(4)-(6).

⁵²² The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii).

Automatic excess benefit transactions, disqualified persons, taxable distributions, and more than incidental benefit

Automatic excess benefit transactions

Under the provision, any grant, loan, compensation, or other similar payment from a donor advised fund to a person that with respect to such fund is a donor, donor advisor, or a person related⁵²³ to a donor or donor advisor automatically is treated as an excess benefit transaction under section 4958, with the entire amount⁵²⁴ paid to any such person treated as the amount of the excess benefit. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment pursuant to bona fide sale or lease of property, which instead are subject to the general rules of section 4958 under the special disqualified person rule of the provision described below. Also as described below, payment by a sponsoring organization of, for example, compensation to a person who both is a donor with respect to a donor advised fund of the sponsoring organization and a service provider with respect to the sponsoring organization generally, will not be subject to the automatic excess benefit transaction rule of the provision unless the payment (of a grant, loan, compensation, or other similar payment) properly is viewed as a payment from the donor advised fund and not from the sponsoring organization.

Any amount repaid as a result of correcting an excess benefit transaction shall not be held in any donor advised fund.

Disqualified persons

In general, the provision provides that donors and donor advisors with respect to a donor advised fund (as well as persons related to a donor or donor advisor) are treated as disqualified persons under section 4958 with respect to transactions with such donor advised fund (though not necessarily with respect to transactions with the sponsoring organization more generally). For example, if a donor to a donor advised fund purchased securities from the fund, the purchase is subject to the rules of section 4958 because, under the provision, the donor is a disqualified person with respect to the fund. Thus, if as a result of the purchase, the donor receives an excess benefit as defined under generally applicable section 4958 rules, then the donor is subject to tax under such rules. If, as generally would be the case, the purchase was of securities that were contributed by the donor, a factor that may indicate the presence of an excess benefit is if the amount paid by the donor to acquire the securities is less than the amount the donor claimed the

⁵²³ For purposes of the provision, a person is treated as related to another person if (1) such person bears a relationship to such other person similar to the relationships described in sections 4958(f)(1)(B) and 4958(f)(1)(C).

⁵²⁴ The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

securities were worth for purposes of any charitable contribution deduction of the donor. In addition, if a donor advised fund distributes securities to the sponsoring organization of the fund prior to purchase by the donor, consideration should be given to whether the distribution to the sponsoring organization prior to the purchase was intended to circumvent the disqualified person rule of the provision. If so, such a distribution may be disregarded with the result that the purchase is treated as being made from the donor advised fund and not from the sponsoring organization.

As a factual matter, a person who is a donor to a donor advised fund and thus a disqualified person with respect to the fund also may be a service provider with respect to the sponsoring organization. In general, under the provision, as under present law, the sponsoring organization's transactions with the service provider are not subject to the rules of section 4958 unless the service provider is a disqualified person with respect to the sponsoring organization (e.g., if the service provider serves on the board of directors of the sponsoring organization), or unless the transaction is not properly viewed as a transaction with the sponsoring organization but in substance is a transaction with the service provider's donor advised fund. If the transaction properly is viewed as a transaction with the donor advised fund of a sponsoring organization, then the transaction is subject to the rules of section 4958, and, as described above, if the transaction involves payment of a grant, loan, compensation, or other similar payment, then the transaction is subject to the special automatic excess benefit transaction rule of the provision. For example, if a sponsoring organization pays an amount as part of a service contract to a service provider (a bank, for example) who also is a donor to a donor advised fund of the sponsoring organization, and such amounts reasonably are charged uniformly in whole or in part as routine fees to all of the sponsoring organization's donor advised funds, the transaction generally is considered to be between the sponsoring organization and the service provider in such service provider's capacity as a service provider. The transaction is not considered to be a transaction between a donor advised fund and the service provider even though an amount paid under the contract was charged to a donor advised fund of the service provider.

The provision provides that an investment advisor (as well as persons related to the investment advisor) is treated as a disqualified person under section 4958 with respect to the sponsoring organization. Under the provision, the term "investment advisor" means, with respect to any sponsoring organization, any person (other than an employee of the sponsoring organization) compensated by the sponsoring organization for managing the investment of, or providing investment advice with respect to, assets maintained in donor advised funds (including pools of assets all or part of which are attributed to donor advised funds) owned by the sponsoring organization.

Taxable distributions

Under the provision, certain distributions from a donor advised fund are subject to tax. A "taxable distribution" is any distribution from a donor advised fund to (1) any natural person;⁵²⁵

⁵²⁵ Under the provision, the term disqualified supporting organization means, with respect to any distribution from a donor advised fund: (1) a Type III supporting organization, other than a functionally integrated Type III supporting organization; and (2) any other supporting organization if either (a) the

(2) to any other person for any purpose other than one specified in section 170(c)(2)(B) (generally, a charitable purpose) or, if for a charitable purpose, the sponsoring organization does not exercise expenditure responsibility with respect to the distribution in accordance with section 4945(h). The expenditure responsibility rules generally require that an organization exert all reasonable efforts and establish adequate procedures to see that the distribution is spent solely for the purposes for which made, to obtain full and complete reports from the distributee on how the funds are spent, and to make full and detailed reports with respect to such expenditures to the Secretary. A taxable distribution does not in any case include a distribution to (1) an organization described in section 170(b)(1)(A)⁵²⁶ (other than to a disqualified supporting organization); (2) the sponsoring organization of such donor advised fund; or (3) to another donor advised fund.⁵²⁷

In the event of a taxable distribution, an excise tax equal to 20 percent of the amount of the distribution is imposed against the sponsoring organization. In addition, an excise tax equal to five percent of the amount of the distribution is imposed against any manager of the sponsoring organization (defined in a manner similar to the term “foundation manager” under section 4945) who knowingly approved the distribution, not to exceed \$10,000 with respect to any one taxable distribution. The taxes on taxable distributions are subject to abatement under generally applicable present law rules.

More than incidental benefit

Under the provision, if a donor, a donor advisor, or a person related to a donor or donor advisor of a donor advised fund provides advice as to a distribution that results in any such person receiving, directly or indirectly, a more than incidental benefit, an excise tax equal to 125 percent of the amount of such benefit is imposed against the person who advised as to the

donor or donor advisor of the distributing donor advised fund directly or indirectly controls a supported organization of the supporting organization, or (b) the Secretary determines by regulations that a distribution to such supporting organization otherwise is inappropriate.

⁵²⁶ For purposes of the requirement that a distribution be “to” an organization described in section 170(b)(1)(A), in general, it is intended that rules similar to the rules of Treasury regulation section 53.4945-5(a)(5) apply. Under such regulations, for purposes of determining whether a grant by a private foundation is “to” an organization described in section 509(a)(1), (2), or (3) and so not a taxable expenditure under section 4945, a foreign organization that otherwise is not a section 509(a)(1), (2), or (3) organization is considered as such if the private foundation makes a good faith determination that the grantee is such an organization. Similarly, under the provision, if a sponsoring organization makes a good faith determination (under standards similar to those currently applicable for private foundations) that a distributee organization is an organization described in section 170(b)(1)(A) (other than a disqualified supporting organization), then a distribution to such organization is not considered a taxable distribution.

⁵²⁷ Under the provision, sponsoring organizations may make grants to natural persons from amounts not held in donor advised funds and may establish scholarship funds that are not donor advised funds. A donor may choose to make a contribution directly to such a scholarship fund (or advise that a donor advised fund make a distribution to such a scholarship fund).

distribution, and against the recipient of the benefit. Persons subject to the tax are jointly and severally liable for the tax. In addition, if a manager of the sponsoring organization (defined in a manner similar to the term “foundation manager” under section 4945) agreed to the making of the distribution, knowing that the distribution would confer a more than incidental benefit on a donor, a donor advisor, or a person related to a donor or donor advisor, the manager is subject to an excise tax equal to 10 percent of the amount of such benefit, not to exceed \$10,000. The taxes on more than incidental benefit are subject to abatement under generally applicable present law rules.

In general, under the provision, there is a more than incidental benefit if, as a result of a distribution from a donor advised fund, a donor, donor advisor, or related person with respect to such fund receives a benefit that would have reduced (or eliminated) a charitable contribution deduction if the benefit was received as part of the contribution to the sponsoring organization. If, for example, a donor advises a that a distribution from the donor’s donor advised fund be made to the Girl Scouts of America, and the donor’s daughter is a member of a local unit of the Girl Scouts of America, the indirect benefit the donor receives as a result of such contribution is considered incidental under the provision, as it generally would not have reduced or eliminated the donor’s deduction if it had been received as part of a contribution by donor to the sponsoring organization.⁵²⁸

Reporting and disclosure

The provision requires each sponsoring organization to disclose on its information return: (1) the total number of donor advised funds it owns; (2) the aggregate value of assets held in those funds at the end of the organization’s taxable year; and (3) the aggregate contributions to and grants made from those funds during the year.

In addition, when seeking recognition of its tax-exempt status, a sponsoring organization must disclose whether it intends to maintain donor advised funds. It is intended that the organization must provide information regarding its planned operation of such funds, including, for example, a description of procedures it intends to use to: (1) communicate to donors and donor advisors that assets held in donor advised funds are the property of the sponsoring organization; and (2) ensure that distributions from donor advised funds do not result in more than incidental benefit to any person.

Effective Date

The provision generally is effective for taxable years beginning after the date of enactment. The provision relating to excess benefit transactions is effective for transactions occurring after the date of enactment. Information return requirements are effective for taxable years ending after the date of enactment. The requirements concerning disclosures on an organization’s application for tax exemption are effective for organizations applying for recognition of exempt status after the date of enactment. Requirements relating to charitable

⁵²⁸ See, e.g., Rev. Rul. 80-77, 1980-1 C.B. 56; Rev. Proc. 90-12, 1990-1 C.B. 471.

contributions to donor advised funds are effective for contributions made after 180 days from the date of enactment.

18. Improve accountability of supporting organizations (secs. 509, 4942, 4943, 4945, 4958, and 6033 of the Code)

Present Law

Requirements for section 501(c)(3) tax-exempt status

Charitable organizations, i.e., organizations described in section 501(c)(3), generally are exempt from Federal income tax and are eligible to receive tax deductible contributions. A charitable organization must operate primarily in pursuance of one or more tax-exempt purposes constituting the basis of its tax exemption.⁵²⁹ In order to qualify as operating primarily for a purpose described in section 501(c)(3), an organization must satisfy the following operational requirements: (1) the net earnings of the organization may not inure to the benefit of any person in a position to influence the activities of the organization; (2) the organization must operate to provide a public benefit, not a private benefit;⁵³⁰ (3) the organization may not be operated primarily to conduct an unrelated trade or business;⁵³¹ (4) the organization may not engage in substantial legislative lobbying; and (5) the organization may not participate or intervene in any political campaign.

Section 501(c)(3) organizations (with certain exceptions) are required to seek formal recognition of tax-exempt status by filing an application with the IRS (Form 1023). In response to the application, the IRS issues a determination letter or ruling either recognizing the applicant as tax-exempt or not.

In general, organizations exempt from Federal income tax under section 501(a) are required to file an annual information return with the IRS.⁵³² Under present law, the information return requirement does not apply to several categories of exempt organizations. Organizations

⁵²⁹ Treas. Reg. sec. 1.501(c)(3)-1(c)(1). The Code specifies such purposes as religious, charitable, scientific, testing for public safety, literary, or educational purposes, or to foster international amateur sports competition, or for the prevention of cruelty to children or animals. In general, an organization is organized and operated for charitable purposes if it provides relief for the poor and distressed or the underprivileged. Treas. Reg. sec. 1.501(c)(3)-1(d)(2).

⁵³⁰ Treas. Reg. sec. 1.501(c)(3)-1(d)(1)(ii).

⁵³¹ Treas. Reg. sec. 1.501(c)(3)-1(e)(1). Conducting a certain level of unrelated trade or business activity will not jeopardize tax-exempt status.

⁵³² Sec. 6033(a)(1).

exempt from the filing requirement include organizations (other than private foundations), the gross receipts of which in each taxable year normally are not more than \$25,000.⁵³³

Classification of section 501(c)(3) organizations

In general

Section 501(c)(3) organizations are classified either as “public charities” or “private foundations.”⁵³⁴ Private foundations generally are defined under section 509(a) as all organizations described in section 501(c)(3) other than an organization granted public charity status by reason of: (1) being a specified type of organization (i.e., churches, educational institutions, hospitals and certain other medical organizations, certain organizations providing assistance to colleges and universities, or a governmental unit); (2) receiving a substantial part of its support from governmental units or direct or indirect contributions from the general public; or (3) providing support to another section 501(c)(3) entity that is not a private foundation. In contrast to public charities, private foundations generally are funded from a limited number of sources (e.g., an individual, family, or corporation). Donors to private foundations and persons related to such donors together often control the operations of private foundations.

Because private foundations receive support from, and typically are controlled by, a small number of supporters, private foundations are subject to a number of anti-abuse rules and excise taxes not applicable to public charities.⁵³⁵ For example, the Code imposes excise taxes on acts of “self-dealing” between disqualified persons (generally, an enumerated class of foundation insiders⁵³⁶) and a private foundation. Acts of self-dealing include, for example, sales or exchanges, or leasing, of property; lending of money; or the furnishing of goods, services, or facilities between a disqualified person and a private foundation.⁵³⁷ In addition, private non-operating foundations are required to pay out a minimum amount each year as qualifying distributions. In general, a qualifying distribution is an amount paid to accomplish one or more of the organization’s exempt purposes, including reasonable and necessary administrative

⁵³³ Sec. 6033(a)(2); Treas. Reg. sec. 1.6033-2(a)(2)(i); Treas. Reg. sec. 1.6033-2(g)(1). Sec. 6033(a)(2)(A)(ii) provides a \$5,000 annual gross receipts exception from the annual reporting requirements for certain exempt organizations. In Announcement 82-88, 1982-25 I.R.B. 23, the IRS exercised its discretionary authority under section 6033 to increase the gross receipts exception to \$25,000, and enlarge the category of exempt organizations that are not required to file Form 990.

⁵³⁴ Sec. 509(a). Private foundations are either private operating foundations or private non-operating foundations. In general, private operating foundations operate their own charitable programs in contrast to private non-operating foundations, which generally are grant-making organizations. Most private foundations are non-operating foundations.

⁵³⁵ Secs. 4940 - 4945.

⁵³⁶ See sec. 4946(a).

⁵³⁷ Sec. 4941.

expenses.⁵³⁸ Certain expenditures of private foundations are also subject to tax.⁵³⁹ In general, taxable expenditures are expenditures: (1) for lobbying; (2) to influence the outcome of a public election or carry on a voter registration drive (unless certain requirements are met); (3) as a grant to an individual for travel, study, or similar purposes unless made pursuant to procedures approved by the Secretary; (4) as a grant to an organization that is not a public charity or exempt operating foundation unless the foundation exercises expenditure responsibility⁵⁴⁰ with respect to the grant; or (5) for any non-charitable purpose. Additional excise taxes may apply in the event a private foundation holds certain business interests (“excess business holdings”)⁵⁴¹ or makes an investment that jeopardizes the foundation’s exempt purposes.⁵⁴²

Public charities also enjoy certain advantages over private foundations regarding the deductibility of contributions. For example, contributions of appreciated capital gain property to a private foundation generally are deductible only to the extent of the donor’s cost basis.⁵⁴³ In contrast, contributions to public charities generally are deductible in an amount equal to the property’s fair market value, except for gifts of inventory and other ordinary income property, short-term capital gain property, and tangible personal property the use of which is unrelated to the donee organization’s exempt purpose. In addition, under present law, a taxpayer’s deductible contributions generally are limited to specified percentages of the taxpayer’s contribution base, which generally is the taxpayer’s adjusted gross income for a taxable year. The applicable percentage limitations vary depending upon the type of property contributed and the classification of the donee organization. In general, contributions to non-operating private foundations are limited to a smaller percentage of the donor’s contribution base (up to 30 percent) than contributions to public charities (up to 50 percent).⁵⁴⁴

⁵³⁸ Sec. 4942(g)(1)(A). A qualifying distribution also includes any amount paid to acquire an asset used (or held for use) directly in carrying out one or more of the organization’s exempt purposes and certain amounts set-aside for exempt purposes. Sec. 4942(g)(1)(B) and 4942(g)(2).

⁵³⁹ Sec. 4945. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

⁵⁴⁰ In general, expenditure responsibility requires that a foundation make all reasonable efforts and establish reasonable procedures to ensure that the grant is spent solely for the purpose for which it was made, to obtain reports from the grantee on the expenditure of the grant, and to make reports to the Secretary regarding such expenditures. Sec. 4945(h).

⁵⁴¹ Sec. 4943.

⁵⁴² Sec. 4944.

⁵⁴³ A special rule in section 170(e)(5) provides that taxpayer are allowed a deduction equal to the fair market value of certain contributions of appreciated, publicly traded stock contributed to a private foundation.

⁵⁴⁴ Sec. 170(b).

Supporting organizations (section 509(a)(3))

The Code provides that certain “supporting organizations” (in general, organizations that provide support to another section 501(c)(3) organization that is not a private foundation) are classified as public charities rather than private foundations.⁵⁴⁵ To qualify as a supporting organization, an organization must meet all three of the following tests: (1) it must be organized and at all times operated exclusively for the benefit of, to perform the functions of, or to carry out the purposes of one or more “publicly supported organizations”⁵⁴⁶ (the “organizational and operational tests”);⁵⁴⁷ (2) it must be operated, supervised, or controlled by or in connection with one or more publicly supported organizations (the “relationship test”);⁵⁴⁸ and (3) it must not be controlled directly or indirectly by one or more disqualified persons (as defined in section 4946) other than foundation managers and other than one or more publicly supported organizations (the “lack of outside control test”).⁵⁴⁹

To satisfy the relationship test, a supporting organization must hold one of three statutorily described close relationships with the supported organization. The organization must be: (1) operated, supervised, or controlled by a publicly supported organization (commonly referred to as “Type I” supporting organizations); (2) supervised or controlled in connection with a publicly supported organization (“Type II” supporting organizations); or (3) operated in connection with a publicly supported organization (“Type III” supporting organizations).⁵⁵⁰

Type I supporting organizations

In the case of supporting organizations that are operated, supervised, or controlled by one or more publicly supported organizations (Type I supporting organizations), one or more supported organizations must exercise a substantial degree of direction over the policies, programs, and activities of the supporting organization.⁵⁵¹ The relationship between the Type I supporting organization and the supported organization generally is comparable to that of a parent and subsidiary. The requisite relationship may be established by the fact that a majority of the officers, directors, or trustees of the supporting organization are appointed or elected by

⁵⁴⁵ Sec. 509(a)(3).

⁵⁴⁶ In general, supported organizations of a supporting organization must be publicly supported charities described in sections 509(a)(1) or (a)(2).

⁵⁴⁷ Sec. 509(a)(3)(A).

⁵⁴⁸ Sec. 509(a)(3)(B).

⁵⁴⁹ Sec. 509(a)(3)(C).

⁵⁵⁰ Treas. Reg. sec. 1.509(a)-4(f)(2).

⁵⁵¹ Treas. Reg. sec. 1.509(a)-4(g)(1)(i).

the governing body, members of the governing body, officers acting in their official capacity, or the membership of one or more publicly supported organizations.⁵⁵²

Type II supporting organizations

Type II supporting organizations are supervised or controlled in connection with one or more publicly supported organizations. Rather than the parent-subsidiary relationship characteristic of Type I organizations, the relationship between a Type II organization and its supported organizations is more analogous to a brother-sister relationship. In order to satisfy the Type II relationship requirement, generally there must be common supervision or control by the persons supervising or controlling both the supporting organization and the publicly supported organizations.⁵⁵³ An organization generally is not considered to be “supervised or controlled in connection with” a publicly supported organization merely because the supporting organization makes payments to the publicly supported organization, even if the obligation to make payments is enforceable under state law.⁵⁵⁴

Type III supporting organizations

Type III supporting organizations are “operated in connection with” one or more publicly supported organizations. To satisfy the “operated in connection with” relationship, Treasury regulations require that the supporting organization be responsive to, and significantly involved in the operations of, the publicly supported organization. This relationship is deemed to exist where the supporting organization meets both a “responsiveness test” and an “integral part test.”⁵⁵⁵

In general, the responsiveness test requires that the Type III supporting organization be responsive to the needs or demands of the publicly supported organizations. The responsiveness test may be satisfied in one of two ways.⁵⁵⁶ First, the supporting organization may demonstrate that: (1)(a) one or more of its officers, directors, or trustees are elected or appointed by the officers, directors, trustees, or membership of the supported organization; (b) one or more members of the governing bodies of the publicly supported organizations are also officers, directors, or trustees of the supporting organization; or (c) the officers, directors, or trustees of the supporting organization maintain a close continuous working relationship with the officers,

⁵⁵² Id.

⁵⁵³ Treas. Reg. sec. 1.509(a)-4(h)(1).

⁵⁵⁴ Treas. Reg. sec. 1.509(a)-4(h)(2).

⁵⁵⁵ Treas. Reg. sec. 1.509(a)-4(i)(1).

⁵⁵⁶ For an organization that was supporting or benefiting one or more publicly supported organizations before November 20, 1970, additional facts and circumstances, such as an historic and continuing relationship between organizations, also may be taken into consideration to establish compliance with either of the responsiveness tests. Treas. Reg. sec. 1.509(a)-4(i)(1)(ii).

directors, or trustees of the publicly supported organizations; and (2) by reason of such arrangement, the officers, directors, or trustees of the supported organization have a significant voice in the investment policies of the supporting organization, the timing and manner of making grants, the selection of grant recipients by the supporting organization, and otherwise directing the use of the income or assets of the supporting organization.⁵⁵⁷ Alternatively, the responsiveness test may be satisfied if the supporting organization is a charitable trust under state law, each specified supported organization is a named beneficiary under the trust's governing instrument, and the beneficiary organization has the power to enforce the trust and compel an accounting under state law.⁵⁵⁸

In general, the integral part test requires that the Type III supporting organization maintain significant involvement in the operations of one or more publicly supported organizations, and that such publicly supported organizations are in turn dependent upon the supporting organization for the type of support which it provides. There are two alternative methods for satisfying the integral part test. The first alternative is to establish that (1) the activities engaged in for or on behalf of the publicly supported organization are activities to perform the functions of, or carry out the purposes of, such organizations; and (2) these activities, but for the involvement of the supporting organization, normally would be engaged in by the publicly supported organizations themselves.⁵⁵⁹ Organizations that satisfy this “but for” test sometimes are referred to as “functionally integrated” Type III supporting organizations. The second method for satisfying the integral part test is to establish that: (1) the supporting organization pays substantially all of its income to or for the use of one or more publicly supported organizations;⁵⁶⁰ (2) the amount of support received by one or more of the publicly supported organizations is sufficient to insure the attentiveness of the organization or organizations to the operations of the supporting organization (this is known as the “attentiveness requirement”);⁵⁶¹ and (3) a significant amount of the total support of the supporting organization goes to those publicly supported organizations that meet the “attentiveness requirement.”⁵⁶²

⁵⁵⁷ Treas. Reg. sec. 1.509(a)-4(i)(2)(ii).

⁵⁵⁸ Treas. Reg. sec. 1.509(a)-4(i)(2)(iii).

⁵⁵⁹ Treas. Reg. sec. 1.509(a)-4(i)(3)(ii).

⁵⁶⁰ For this purpose, the IRS has defined the term “substantially all” of an organization's income to mean 85 percent or more. Rev. Rul. 76-208, 1976-1 C.B. 161.

⁵⁶¹ Although the regulations do not specify the requisite level of support in numerical or percentage terms, the IRS has suggested that grants that represent less than 10 percent of the beneficiary's support likely would be viewed as insufficient to ensure attentiveness. Gen. Couns. Mem. 36379 (August 15, 1975). As an alternative to satisfying the attentiveness standard by the foregoing method, a supporting organization may demonstrate attentiveness by showing that, in order to avoid the interruption of the carrying on of a particular function or activity, the beneficiary organization will be sufficiently attentive to the operations of the supporting organization. Treas. Reg. sec. 1.509(a)-4(i)(3)(iii)(b).

⁵⁶² Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

Intermediate sanctions (excess benefit transaction tax)

The Code imposes excise taxes on excess benefit transactions between disqualified persons and public charities.⁵⁶³ An excess benefit transaction generally is a transaction in which an economic benefit is provided by a public charity directly or indirectly to or for the use of a disqualified person, if the value of the economic benefit provided exceeds the value of the consideration (including the performance of services) received for providing such benefit.

For purposes of the excess benefit transaction rules, a disqualified person is any person in a position to exercise substantial influence over the affairs of the public charity at any time in the five-year period ending on the date of the transaction at issue.⁵⁶⁴ Persons holding certain powers, responsibilities, or interests (e.g., officers, directors, or trustees) are considered to be in a position to exercise substantial influence over the affairs of the public charity.

An excess benefit transaction tax is imposed on the disqualified person and, in certain cases, on the organization managers, but is not imposed on the public charity. An initial tax of 25 percent of the excess benefit amount is imposed on the disqualified person that receives the excess benefit. An additional tax on the disqualified person of 200 percent of the excess benefit applies if the violation is not corrected within a specified period. A tax of 10 percent of the excess benefit (not to exceed \$10,000 with respect to any excess benefit transaction) is imposed on an organization manager that knowingly participated in the excess benefit transaction, if the manager's participation was willful and not due to reasonable cause, and if the initial tax was imposed on the disqualified person.

Excess business holdings of private foundations

Private foundations are subject to tax on excess business holdings.⁵⁶⁵ In general, a private foundation is permitted to hold 20 percent of the voting stock in a corporation, reduced by the amount of voting stock held by all disqualified persons (as defined in section 4946). If it is established that no disqualified person has effective control of the corporation, a private foundation and disqualified persons together may own up to 35 percent of the voting stock of a corporation. A private foundation shall not be treated as having excess business holdings in any corporation if it owns (together with certain other related private foundations) not more than two percent of the voting stock and not more than two percent in value of all outstanding shares of all classes of stock in that corporation. Similar rules apply with respect to holdings in a partnership ("profits interest" is substituted for "voting stock" and "capital interest" for "nonvoting stock") and to other unincorporated enterprises (by substituting "beneficial interest" for "voting stock").

⁵⁶³ Sec. 4958. The excess benefit transaction tax is commonly referred to as "intermediate sanctions," because it imposes penalties generally considered to be less punitive than revocation of the organization's exempt status. The tax also applies to transactions between disqualified persons and social welfare organizations (as described in section 501(c)(4)).

⁵⁶⁴ Sec. 4958(f)(1). A disqualified person also includes certain family members of such a person, and certain entities that satisfy a control test with respect to such persons.

⁵⁶⁵ Sec. 4943. Taxes imposed may be abated if certain conditions are met. Secs. 4961 and 4962.

Private foundations are not permitted to have holdings in a proprietorship. Foundations generally have a five-year period to dispose of excess business holdings (acquired other than by purchase) without being subject to tax.⁵⁶⁶ This five-year period may be extended an additional five years in limited circumstances.⁵⁶⁷ The excess business holdings rules do not apply to holdings in a functionally related business or to holdings in a trade or business at least 95 percent of the gross income of which is derived from passive sources.⁵⁶⁸

The initial tax is equal to five percent of the value of the excess business holdings held during the foundation's applicable taxable year. An additional tax is imposed if an initial tax is imposed and at the close of the applicable taxable period, the foundation continues to hold excess business holdings. The amount of the additional tax is equal to 200 percent of such holdings.

Explanation of Provision

Provisions relating to all supporting organizations (Type I, Type II, and Type III)

Automatic excess benefit transactions

Under the provision, if a supporting organization (Type I, Type II, or Type III) makes a grant, loan, payment of compensation, or other similar payment to a substantial contributor (or person related to the substantial contributor) of the supporting organization, for purposes of the excess benefit transaction rules (sec. 4958), the substantial contributor is treated as a disqualified person and the payment is treated automatically as an excess benefit transaction with the entire amount of the payment treated as the excess benefit.⁵⁶⁹ Accordingly, the substantial contributor is subject to an initial tax of 25 percent of the amount of the payment under section 4958(a)(1) and an organization manager that participated in the making of the payment, knowing that the payment was a grant, loan, payment of compensation, or other similar payment to a substantial contributor, is subject to a tax of 10 percent of the amount of the payment under section 4958(a)(2). The second tier taxes and other rules of section 4958 also apply to such payments. Other similar payments include payments in the nature of a grant, loan, or payment of compensation, such as an expense reimbursement. Other similar payments do not include, for example, a payment made pursuant to a bona fide sale or lease of property with a substantial contributor. Such payments are subject to the general rules of section 4958 if the substantial contributor meets the definition of a disqualified person under section 4958(f), but are not subject to the automatic excess benefit transaction rule of the provision. The provision applies to

⁵⁶⁶ Sec. 4943(c)(6).

⁵⁶⁷ Sec. 4943(c)(7).

⁵⁶⁸ Sec. 4943(d)(3).

⁵⁶⁹ The requirement of the provision that the entire amount of the payment be treated as the amount of the excess benefit differs from the generally applicable rule of section 4958, which provides that the excess benefit is the amount by which the value of the economic benefit provided exceeds the value of the consideration received.

payments by a supporting organization to a substantial contributor but not to payments by a substantial contributor to a supporting organization.

Under the provision, a substantial contributor means any person who contributed or bequeathed an aggregate amount of more than \$5,000 to the organization, if such amount is more than two percent of the total contributions and bequests received by the organization before the close of the taxable year of the organization in which the contribution or bequest is received by the organization from such person. In the case of a trust, a substantial contributor also includes the creator of the trust. A substantial contributor does not include a public charity (other than a supporting organization). Under the provision, mechanical rules similar to the rules that apply in determining whether a person is a substantial contributor to a private foundation (secs. 509(d)(2)(B) and (C)) apply.

Under the provision, a person is a related person (“related person”) if a person is a member of the family (determined under section 4958(f)(4)) of a substantial contributor, or a 35 percent controlled entity, defined as a corporation, partnership, trust, or estate in which a substantial contributor or family member thereof owns more than 35 percent of the total combined voting power, profits interest, or beneficial interest, as the case may be.

In addition, under the provision, loans by any supporting organization (Type I, Type II, or Type III) to a disqualified person (as defined in section 4958) of the supporting organization are treated as an excess benefit transaction under section 4958 and the entire amount of the loan is treated as an excess benefit. For this purpose, a disqualified person does not include a public charity (other than a supporting organization).

Disclosure requirements

Under the provision, all supporting organizations are required to file an annual information return (Form 990 series) with the Secretary, regardless of the organization’s gross receipts. A supporting organization must indicate on such annual information return whether it is a Type I, Type II, or Type III supporting organization and must identify its supported organizations.

Under the provision, supporting organizations must demonstrate annually that the organization is not controlled directly or indirectly by one or more disqualified persons (other than foundation managers and other than one or more publicly supported organizations) through a certification on the annual information return. It is intended that supporting organizations be able to certify that the majority of the organization’s governing body is comprised of individuals who were selected based on their special knowledge or expertise in the particular field or discipline in which the supporting organization is operating, or because they represent the particular community that is served by the supported public charities.

Disqualified person

Under the provision, for purposes of the excess benefit transaction rules (sec. 4958), a disqualified person of a supporting organization is treated as a disqualified person of the supported organization.

Provisions that apply to Type III supporting organizations

Payout with respect to Type III supporting organizations

Under the provision, the Secretary shall promulgate new regulations on payments required by Type III supporting organizations that are not functionally integrated Type III supporting organizations.⁵⁷⁰ Such regulations shall require such organizations to make distributions of a percentage either of income or assets to the public charities they support in order to ensure that a significant amount is paid to such supported organizations. A functionally integrated Type III supporting organization is a Type III supporting organization that is not required under regulations established by the Secretary to make payments to supported organizations due to the activities of the organization related to performing the functions of, or carrying out the purposes of, such supported organizations.⁵⁷¹

Excess business holdings

Under the provision, the excess business holdings rules of section 4943 are applied to Type III supporting organizations (other than functionally integrated Type III supporting organizations). In applying such rules, the term disqualified person has the meaning provided in section 4958, and also includes substantial contributors and related persons and any organization that is effectively controlled by the same person or persons who control the supporting organization or any organization substantially all of the contributions to which were made by the same person or persons who made substantially all of the contributions to the supporting organization. The excess business holdings rules do not apply if, as of November 18, 2005, the holdings were held (and at all times thereafter, are held) for the benefit of the community pursuant to the direction (made as of such date) of a State attorney general or a State official with jurisdiction over the Type III supporting organization.

⁵⁷⁰ See Treas. Reg. sec. 1.509(a)-4(i)(3)(iii).

⁵⁷¹ The current such regulation is Treasury regulation section 1.509(a)-4(i)(3)(ii). Under Treasury regulation section 1.509(a)-4(i)(3), the integral part test of current law may be satisfied in one of two ways, one of which requires a payout of substantially all of an organization's income to or for the use of one or more publicly supported organizations, and one of which does not require such a payout. There is concern that the current income-based payout does not result in a significant amount being paid to charity if assets held by a supporting organization produce little to no income, especially in relation to the value of the assets held by the organization, and as compared to amounts paid out by nonoperating private foundations. There also is concern that the current regulatory standards for satisfying the integral part test not by reason of a payout are not sufficiently stringent to ensure that there is a sufficient nexus between the supporting and supported organizations. In revising the regulations, the Secretary has the discretion to determine whether it is appropriate to impose a pay out requirement on any or all organizations not currently required to pay out. It is intended that, in revisiting the current regulations, if the distinction between Type III supporting organizations that are required to pay out and those that are not required to pay out is retained, which may be appropriate, the Secretary nonetheless shall strengthen the standard for qualification as an organization that is not required to pay out. For example, as one requirement, the Secretary may consider whether substantially all of the activities of such an organization should be activities in direct furtherance of the functions or purposes of supported organizations.

The Secretary has the authority not to impose the excess business holdings rules if the organization establishes to the satisfaction of the Secretary that excess holdings of an organization are consistent with the purpose or function constituting the basis of the organization's exempt status. In exercising this authority, the Secretary should consider, in addition to any other factors the Secretary considers significant, as favorable, but not determinative, factors, a reasoned determination by the State attorney general with jurisdiction over the supporting organization, that disposition of the holdings would have a severe detrimental impact on the community, and a binding commitment by the supporting organization to pay out at least five percent of the value of the organization's assets each year to its supported organizations. A reasoned determination would require, among other things, evidence that any such determination was made pursuant to serious study by the State attorney general of the issues involved in disposing of the excess holdings, and findings by the State attorney general about the detrimental economic impact that would result from such disposition. If as a result of such State attorney general's study and findings, the State attorney general directed as a matter of State law that permission of the State would be required prior to any sale of the holdings, such a factor should be given strong consideration by the Secretary.

Transition rules apply to the present holdings of an organization similar to those of section 4943(c)(4)-(6).⁵⁷²

Under the provision, the excess business holdings rules also apply to Type II supporting organizations but only if such organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization,⁵⁷³ (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity.

Organizational and operational requirements

⁵⁷² Under the transition rules, in general, where the existing holdings of a supporting organization and disqualified persons are in excess of 50 percent (of a voting stock interest, profits interest, or beneficial interest), and not 20 percent or 35 percent as under the general rule, but are not in excess of 75 percent, a 10-year period is available before the holdings must be reduced to 50 percent. If such holdings are more than 75 percent, the reduction to 50 percent need not occur for a 15-year period. The 15-year period is expanded to 20 years if the holdings are more than 95 percent. After the expiration of the 10, 15, or 20 year period, if disqualified persons have holdings in a business enterprise in excess of two percent of the enterprise, the supporting organization has 15 additional years to dispose of any of its own holdings that are above 25 percent of the holdings in the enterprise. If disqualified persons do not have such holdings, then the supporting organization has 15 additional years to dispose of any of its own holdings that are above 35 percent of the holdings in the enterprise.

⁵⁷³ For purposes of the provision, it is intended that indirect control includes the ability to exercise effective control. For example, if a person made a gift to a supporting organization and a combination of such person, a person related to such person, and such person's personal attorney were members of the five-member board of a supported organization of the supporting organization, the organization would be treated as being indirectly controlled by such person. Board membership alone does not establish direct or indirect control.

The provision provides that, in general, after the date of enactment, a Type III supporting organization may not support an organization that is not organized in the United States.⁵⁷⁴ But, for Type III supporting organizations that support a foreign organization on the date of enactment, the provision provides that the general rule does not apply until the first day of the third taxable year of the organization beginning after the date of enactment.

Relationship to supported organization(s)

Under the provision, a Type III supporting organization must apprise each organization it supports of information regarding the supporting organization in order to help ensure the supporting organization's responsiveness. It is intended that such a showing could be satisfied, for example, through provision of documentation such as a copy of the supporting organization's governing documents, any changes made to the governing documents, the organization's annual information return filed with the Secretary (Form 990 series), any tax return (Form 990-T) filed with the Secretary, and an annual report (including a description of all of the support provided by the supporting organization, how such support was calculated, and a projection of the next year's support). It is intended that failure to make a sufficient showing is a factor in determining whether the responsiveness test of present law is met.

In general, under the provision, a Type III supporting organization that is organized as a trust must, in addition to present law requirements, establish to the satisfaction of the Secretary, that it has a close and continuous relationship with the supported organization such that the trust is responsive to the needs or demands of the supported organization. A transition rule for existing trusts provides that the provision is not effective until one year after the date of enactment but is effective on the date of enactment for other trusts.

Other provisions

Under the provision, if a Type I or Type III supporting organization accepts any gift or contribution from a person (other than a public charity, not including a supporting organization) who (1) controls, directly or indirectly, either alone or together (with persons described below) the governing body of a supported organization of the supporting organization; (2) is a member of the family of such a person; or (3) is a 35 percent controlled entity, then the supporting organization is treated as a private foundation for all purposes until such time as the organization can demonstrate to the satisfaction of the Secretary that it qualifies as a public charity other than as a supporting organization.

Under the provision, a nonoperating private foundation may not count as a qualifying distribution under section 4942 any amount paid to (1) a Type III supporting organization that is not a functionally integrated Type III supporting organization or (2) any other supporting

⁵⁷⁴ U.S. charities established principally to provide financial and other assistance to a foreign charity, sometimes referred to as "friends of" organizations, may not be established as supporting organizations under the provision. Such organizations may continue to obtain public charity status, however, by virtue of demonstrating broad public support (as described in sections 509(a)(1) and 509(a)(2)).

organization if a disqualified person with respect to the foundation directly or indirectly controls the supporting organization or a supported organization of such supporting organization. Any amount that does not count as a qualifying distribution under this rule is treated as a taxable expenditure under section 4945.

Effective Date

The provision generally is effective on the date of enactment. The excess benefit transaction rules are effective for transactions occurring after July 25, 2006 (except that the rule relating to the definition of a disqualified person is effective for transactions occurring after the date of enactment). The excess business holdings requirements are effective for taxable years beginning after the date of enactment. The provision relating to distributions by nonoperating private foundations is effective for distributions and expenditures made after the date of enactment. The return requirements are effective for returns filed for taxable years ending after the date of enactment.

TITLE XIII: OTHER PROVISIONS

A. Technical Corrections to Mine Safety Act⁵⁷⁵

The bill makes technical corrections to the Mine Improvement and New Emergency Response Act (“MINER Act”) of 2006 (Pub. L. No. 109-236). Specifically, the provision corrects a drafting error by recodifying the MINER Act’s provisions increasing criminal penalties under the Mine Safety and Health Act at 30 U.S.C. s. 820(d), as was intended, and makes other technical and conforming changes.

B. Going To The Sun Road

Present Law

Section 1940 of the Safe, Accountable, Flexible, Efficient Transportation Equity Act: a Legacy for Users (“SAFETEA-LU”) provides authorization for the appropriation of \$50 million in funding for work to resurface, repair, rehabilitate and reconstruct the Going to the Sun Road at Glacier National Park Montana (\$10 million per year for fiscal years 2005 through 2009).

Section 10212 of SAFETEA-LU rescinds a specified amount of unobligated balances of funds apportioned before September 30, 2009, to States for the Interstate maintenance, national highway system, bridge, congestion mitigation and air quality improvement, surface transportation (other than the STP set-aside programs), metropolitan planning, minimum guarantee, Appalachian development highway system, recreational trails, safe routes to school, freight intermodal connectors, coordinated border infrastructure, high risk rural road, and highway safety improvement programs. The specified amount is \$8,543,000,000.

Explanation of Provision

The provision eliminates the authorizations for fiscal years 2005 and 2006, and redistributes those funds as \$16,666,666 per year for fiscal years 2007 through 2009. The provision further provides that funds authorized to be appropriated under the provision are contract authority to be available for obligation in the same manner as if the funds were apportioned under chapter 1 of title 23 of the United States Code. The provision increases by \$50 million the specified amount subject to rescission from \$8,543,000,000 to \$8,593,000,000.

Effective Date

The provision is effective on the date of enactment.

⁵⁷⁵ The description of these provisions, which do not amend the Internal Revenue Code of 1986, was provided to the staff of the Joint Committee on Taxation by staff of the House Committee on Education and the Workforce.

C. Exception to Local Furnishing Requirements for Certain Alaska Hydroelectric Projects

Present Law

Interest on bonds issued by State and local governments generally is excluded from gross income for Federal income tax purposes if the proceeds of such bonds are used to finance direct activities of governmental units or if such bonds are repaid with revenues of governmental units. Interest on State or local government bonds issued to finance activities of private persons is taxable unless a specific exception applies (“private activity bonds”).

The interest on private activity bonds is eligible for tax-exemption if such bonds are issued for certain purposes permitted by the Code (“qualified private activity bonds”). The definition of a qualified private activity bond includes bonds issued to finance certain private facilities for the “local furnishing” of electricity or gas. Generally, a facility provides local furnishing if the area served by the facility does not exceed (1) two contiguous counties or (2) a city and a contiguous county (the “two-county rule”).

The Code generally limits the local furnishing exception to bonds for facilities (1) of persons who were engaged in the local furnishing of electric energy or gas on January 1, 1997 (or a successor in interest to such persons), and (2) that serve areas served by those persons on such date (the “service area limitation”) (sec. 142(f)(3)). The Small Business Job Protection Act of 1996 (the “Act”) provided an exception from these limitations for bonds issued to finance the acquisition of the Snettisham hydroelectric project from the Alaska Power Administration (Pub. L. No. 104-188, sec. 1804 (1996)).

Explanation of Provision

The provision provides an exception from the service area limitation under section 142(f)(3) for bonds issued prior to May 31, 2006, to finance the Lake Dorothy hydroelectric project to provide electricity to the City of Hoonah, Alaska. In addition, the furnishing of electric service to the City of Hoonah, Alaska is disregarded for purposes of applying the two-county rule to bonds issued before May 31, 2006, to finance either the Lake Dorothy hydroelectric project (as defined in the provision) or to finance the acquisition of the Snettisham hydroelectric project.

Effective Date

The provision is effective on the date of enactment.

D. Extend Certain Tax Rules for Qualified Tuition Programs (sec. 529 of the Code)

Present Law

Overview

Section 529 provides specified income tax and transfer tax rules for the treatment of accounts and contracts established under qualified tuition programs.⁵⁷⁶ A qualified tuition program is a program established and maintained by a State or agency or instrumentality thereof, or by one or more eligible educational institutions, which satisfies certain requirements and under which a person may purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to the waiver or payment of qualified higher education expenses of the beneficiary (a “prepaid tuition program”).⁵⁷⁷ In the case of a program established and maintained by a State or agency or instrumentality thereof, a qualified tuition program also includes a program under which a person may make contributions to an account that is established for the purpose of satisfying the qualified higher education expenses of the designated beneficiary of the account, provided it satisfies certain specified requirements (a “savings account program”).⁵⁷⁸ Under both types of qualified tuition programs, a contributor establishes an account for the benefit of a particular designated beneficiary to provide for that beneficiary’s higher education expenses.

For this purpose, qualified higher education expenses means tuition, fees, books, supplies, and equipment required for the enrollment or attendance of a designated beneficiary at an eligible educational institution, and expenses for special needs services in the case of a special needs beneficiary that are incurred in connection with such enrollment or attendance.⁵⁷⁹ Qualified higher education expenses generally also include room and board for students who are enrolled at least half-time.⁵⁸⁰

Income tax treatment

A qualified tuition program, including a savings account or a prepaid tuition contract established thereunder, generally is exempt from income tax, although it is subject to the tax on unrelated business income.⁵⁸¹ Contributions to a qualified tuition account (or with respect to a

⁵⁷⁶ The term “account” refers to a prepaid tuition benefit contract or a tuition savings account established pursuant to a qualified tuition program.

⁵⁷⁷ Sec. 529(b)(1)(A).

⁵⁷⁸ Sec. 529(b)(1)(A).

⁵⁷⁹ Sec. 529(e)(3)(A).

⁵⁸⁰ Sec. 529(e)(3)(B).

⁵⁸¹ Sec. 529(a). An interest in a qualified tuition account is not treated as debt for purposes of the debt-financed property rules under section 514. Sec. 529(e)(4).

prepaid tuition contract) are not deductible to the contributor or includible in income of the designated beneficiary or account owner. Earnings accumulate tax-free until a distribution is made. If a distribution is made to pay qualified higher education expenses, no portion of the distribution is subject to income tax.⁵⁸² If a distribution is not used to pay qualified higher education expenses, the earnings portion of the distribution is subject to Federal income tax⁵⁸³ and a 10-percent additional tax (subject to exceptions for death, disability, or the receipt of a scholarship).⁵⁸⁴ A change in the designated beneficiary of an account or prepaid contract is not treated as a distribution for income tax purposes if the new designated beneficiary is a member of the family of the old beneficiary.⁵⁸⁵

Gift and generation-skipping transfer (GST) tax treatment

A contribution to a qualified tuition account (or with respect to a prepaid tuition contract) is treated as a completed gift of a present interest from the contributor to the designated beneficiary.⁵⁸⁶ Such contributions qualify for the per-donee annual gift tax exclusion (\$12,000 for 2006), and, to the extent of such exclusions, also are exempt from the generation-skipping transfer (GST) tax. A contributor may contribute in a single year up to five times the per-donee annual gift tax exclusion amount to a qualified tuition account and, for gift tax and GST tax purposes, treat the contribution as having been made ratably over the five-year period beginning with the calendar year in which the contribution is made.⁵⁸⁷

A distribution from a qualified tuition account or prepaid tuition contract generally is not subject to gift tax or GST tax.⁵⁸⁸ Those taxes may apply, however, to a change of designated

⁵⁸² Sec. 529(c)(3)(B). Any benefit furnished to a designated beneficiary under a qualified tuition account is treated as a distribution to the beneficiary for these purposes. Sec. 529(c)(3)(B)(iv).

⁵⁸³ Sec. 529(c)(3)(A) and (B)(ii).

⁵⁸⁴ Sec. 529(c)(6).

⁵⁸⁵ Sec. 529(c)(3)(C)(ii). For this purpose, “member of the family” means, with respect to a designated beneficiary: (1) the spouse of such beneficiary; (2) an individual who bears a relationship to such beneficiary which is described in paragraphs (1) through (8) of section 152(a) (i.e., with respect to the beneficiary, a son, daughter, or a descendant of either; a stepson or stepdaughter; a sibling or stepsibling; a father, mother, or ancestor of either; a stepfather or stepmother; a son or daughter of a brother or sister; a brother or sister of a father or mother; and a son-in-law, daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law), or the spouse of any such individual; and (3) the first cousin of such beneficiary. Sec. 529(e)(2).

⁵⁸⁶ Sec. 529(c)(2)(A).

⁵⁸⁷ Sec. 529(c)(2)(B).

⁵⁸⁸ Sec. 529(c)(5)(A).

beneficiary if the new designated beneficiary is in a generation below that of the old beneficiary or if the new beneficiary is not a member of the family of the old beneficiary.⁵⁸⁹

Estate tax treatment

Qualified tuition program account balances or prepaid tuition benefits generally are excluded from the gross estate of any individual.⁵⁹⁰ Amounts distributed on account of the death of the designated beneficiary, however, are includible in the designated beneficiary's gross estate.⁵⁹¹ If the contributor elected the special five-year allocation rule for gift tax annual exclusion purposes, any amounts contributed that are allocable to the years within the five-year period remaining after the year of the contributor's death are includible in the contributor's gross estate.⁵⁹²

Certain provisions expiring under the Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA")

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") made a number of changes to the rules regarding qualified tuition programs. However, in order to comply with reconciliation procedures under the Congressional Budget Act of 1974, EGTRRA included a "sunset" provision, pursuant to which the provisions of the Act expire at the end of 2010. Specifically, EGTRRA's provisions do not apply for taxable, plan, or limitation years beginning after December 31, 2010, or to estates of decedents dying after, or gifts or generation-skipping transfers made after, December 31, 2010. EGTRRA provides that, as of the effective date of the sunset, the Code will be applied as though EGTRRA had never been enacted.

The provisions of present-law section 529 scheduled to expire by reason of the EGTRRA sunset provision include: (1) the provision that makes qualified withdrawals from qualified tuition accounts exempt from income tax; (2) the repeal of a pre-EGTRRA requirement that there be more than a de minimis penalty imposed on amounts not used for educational purposes and the imposition of the 10-percent additional tax on distributions not used for qualified higher education purposes; (3) a provision permitting certain private educational institutions to establish prepaid tuition programs that qualify under section 529 if they receive a ruling or determination to that effect from the Internal Revenue Service, and if the assets are held in a trust created or organized for the exclusive benefit of designated beneficiaries; (4) certain provisions permitting rollovers from one account to another account; (5) certain rules regarding the treatment of room and board as qualifying expenses; (6) certain rules regarding coordination with Hope and lifetime learning credit provisions; (7) the provision that treats first cousins as members of the

⁵⁸⁹ Sec. 529(c)(5)(B).

⁵⁹⁰ Sec. 529(c)(4)(A).

⁵⁹¹ Sec. 529(c)(4)(B).

⁵⁹² Sec. 529(c)(4)(C).

family for purposes of the rollover and change in beneficiary rules; and (8) certain provisions regarding the education expenses of special needs beneficiaries.⁵⁹³

Explanation of Provision

Permanently extend EGTRRA modifications to qualified tuition program rules

The provision repeals the sunset provision of EGTRRA insofar as it applies to the EGTRRA modifications to the rules regarding qualified tuition programs. As a result, the provision permanently extends all provisions of EGTRRA that expire at the end of 2010 that relate to qualified tuition programs.

Grant of regulatory authority to Treasury

Present law regarding the transfer tax treatment of qualified tuition program accounts is unclear and in some situations imposes tax in a manner inconsistent with generally applicable transfer tax provisions. In addition, present law creates opportunities for abuse of qualified tuition programs. For example, taxpayers may seek to avoid gift and generation skipping transfer taxes by establishing and contributing to multiple qualified tuition program accounts with different designated beneficiaries (using the provision of section 529 that permits a contributor to contribute up to five times the annual exclusion amount per donee in a single year and treat the contribution as having been made ratably over five years), with the intention of subsequently changing the designated beneficiaries of such accounts to a single, common beneficiary and distributing the entire amount to such beneficiary without further transfer tax consequences. Taxpayers also may seek to use qualified tuition program accounts as retirement accounts with all of the tax benefits but none of the restrictions and requirements of qualified retirement accounts. The provision grants the Secretary broad regulatory authority to clarify the tax treatment of certain transfers and to ensure that qualified tuition program accounts are used for the intended purpose of saving for higher education expenses of the designated beneficiary, including the authority to impose related recordkeeping and reporting requirements. The provision also authorizes the Secretary to limit the persons who may be contributors to a qualified tuition program and to determine any special rules for the operation and Federal tax consequences of such programs if such contributors are not individuals.

Effective Date

The provision is effective on the date of enactment.

⁵⁹³ EGTRRA sec. 402.

TITLE XIV: TARIFF PROVISIONS⁵⁹⁴

A. Suspension of Duties on Liquid Crystal Device (LCD) Panel Assemblies for Use in LCD Direct View Televisions

Present Law

Present law provides for a 4.5 percent ad valorem customs duty on imported liquid crystal device (LCD) panel assemblies for use in LCD direct view televisions from all sources (provided for in subheading 9013.80.90 of the Harmonized Tariff Schedule of the United States).

Explanation of Provision

The provision suspends the present customs duty applicable to LCD panel assemblies for use in LCD direct view televisions through December 31, 2009.

Effective Date

The provision applies with respect to goods entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of the enactment.

B. Suspension of Duties on Ceiling Fans

Present Law

Present law provides for a 4.7-percent ad valorem customs duty on imported ceiling fans from all sources (provided for in subheading 8414.51.00 of the Harmonized Tariff Schedule of the United States), but that duty is currently suspended for all imports until December 31, 2006.

Explanation of Provision

The provision extends the current suspension of the customs duty applicable to ceiling fans through December 31, 2009.

Effective Date

The provision applies with respect to goods entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of the enactment.

⁵⁹⁴ The description of these provisions, which do not amend the Internal Revenue Code of 1986, was provided to the staff of the Joint Committee on Taxation by staff of the House Committee on Ways and Means and the Senate Committee on Finance.

**C. Suspension of Duties on Nuclear Steam Generators,
Reactor Vessel Heads and Pressurizers**

Present Law

Nuclear steam generators, as classified under heading 9902.84.02 of the Harmonized Tariff Schedule of the United States, enter the United States duty free until December 31, 2008. After December 31, 2008, the duty on nuclear steam generators returns to the column 1 rate of 5.2 percent under subheading 8402.11.00 of the Harmonized Tariff Schedule of the United States.

Nuclear reactor vessel heads and pressurizers, as classified under heading 9902.84.03 of the Harmonized Tariff Schedule of the United States, enter the United States duty free until December 31, 2008. After December 31, 2008, the duty on nuclear reactor vessel heads and pressurizers returns to the column 1 rate of 3.3 percent under subheading 8401.40.00 of the Harmonized Tariff Schedule of the United States.

Explanation of Provision

With respect to imported nuclear steam generators, reactor vessel heads, and pressurizers, that are purchased pursuant to a contract entered into on or before July 31, 2006, the provision extends the present-law suspension of applicable customs duty through December 31, 2010.

Effective Date

The provision is effective with respect to goods entered, or withdrawn from warehouse for consumption, on or after the 15th day after the date of enactment.

D. Suspension of New Shipper Bonding Privilege

Present Law

Once an antidumping or countervailing duty order is in place, importers of subject merchandise are required to post cash deposits to cover the estimated duties. An exception is made for importers of subject merchandise from new shippers (foreign producers or exporters) who were not selling to the United States at the time of the original investigation and who have requested a review of their shipments to determine individual dumping margins or countervailing duty rates. During the pendency of such a review, an importer of subject merchandise from a new shipper may choose to post a bond or security in lieu of a cash deposit of estimated duties.

Explanation of Provision

The provision temporarily suspends the ability of importers of subject merchandise from new shippers to choose to post a bond or security in lieu of a cash deposit of estimated duties during the period beginning on April 1, 2006, through June 30, 2009.

The provision requires the Secretary of the Treasury, in consultation with the Secretary of Commerce and the Secretary of Homeland Security, to submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report describing: (1) any major problem encountered in the collection of duties, including any fraudulent activity intended to avoid the payment of duties; (2) an estimate of duties that were uncollected and a description of why the duties were uncollected; and (3) recommendations on any additional action needed to address problems related to the collection of duties.

In addition, the provision requires the Secretary of the Treasury, in consultation with the Secretary of Commerce, the United States Trade Representative, and the Secretary of Homeland Security, to submit to the Committee on Ways and Means of the House of Representatives and the Committee on Finance of the Senate a report containing: (1) recommendations on whether the temporary suspension of the new shipper bonding privilege should be extended beyond June 30, 2009; (2) an assessment of the effectiveness of any administrative measure taken to address problems encountered in the collection of duties from importers of subject merchandise from new shippers; and (3) an assessment of any burden imposed on legitimate trade and commerce by the temporary suspension of the new shipper bonding privilege.

Effective Date

The provision is effective on the date of enactment, and it applies to imports from new shippers during the period beginning on April 1, 2006, through June 30, 2009.

E. Wool Trust Fund and Wool Fabric Duty Suspension

Present Law

Present law enacted in the Trade Act of 2002 and extended in the Miscellaneous Trade Bill of 2004 provides for temporary duty reductions or duty suspensions of certain fabrics made from worsted wool and for payments made under the wool trust fund. The fund consists of three special refund pools for importers of wool fabric, wool yarn, and wool fiber and top, and identifies all persons eligible for the refunds including U.S. manufacturers of these products. The program expires in 2007.

Explanation of Provision

The provision extends the current program for an additional two years until 2009.

Effective Date

The provision is effective on the date of enactment.

F. Miscellaneous Trade and Technical Corrections Provisions

Present Law

Under present law, imports of the goods described in Title I of Division B of the bill enter under the specified Harmonized Tariff Schedule subheading with the associated tariff rate.

Explanation of Provision

The bill includes certain provisions taken from the House-passed H.R. 4944, the Miscellaneous Trade and Technical Corrections Act of 2006, for which there are Senate companions introduced, which suspend or reduce the tariff rate on certain selected products. The provisions also correct government errors or authorize reliquidations of duties related to certain products.

Effective Date

The effective date is the 15th day after the date of enactment.

G. Vessel Repair Duties

Present law

Under present law, section 466(h) of the Tariff Act of 1930 (19 U.S.C. 1466(h)), the cost of equipment, repair parts, and materials that are installed on a vessel documented under the laws of the United States and engaged in the foreign or coasting trade, if the installation is done by members of the regular crew of such vessel while the vessel is on the high seas, is excluded from a 50 percent ad valorem duty.

Explanation of Provision

This provision clarifies that the 50 percent ad valorem duty on vessel repairs excludes the cost of equipment, repair parts, and materials that are installed on a vessel documented under the laws of the United States and engaged in the foreign or coasting trade, if the installation is done by members of the regular crew of such vessel while the vessel is on the high seas, in foreign waters, or in a foreign port, and does not involve foreign shipyard repairs by foreign labor.

Effective Date

The provision is effective on the date of enactment, and it applies to vessel equipment, repair parts, and materials installed on or after April 25, 2001.

H. CAFTA-DR Provisions Related to Agreement Implementation

Present Law

Present law enacted in the Dominican Republic-Central America-United States Free Trade Agreement (CAFTA-DR) Implementation Act allows the President to exercise proclamation authority to implement provisions of the Agreement including tariffs and rules of origin changes, except for rules of origin changes for certain textile and apparel items. Also, current law was drafted under the assumption at the time of enactment of this legislation that the entry into force for all CAFTA-DR countries would be identical including for the purpose of determining the rule of origin covering co-produced products.

Explanation of Provision

The provision extends narrow proclamation authority to the President to implement specific proposed changes to the rules of origin for certain apparel items and certain trade preference level administrative changes as embodied in letters of understanding between the United States and several of the CAFTA-DR countries. For those countries that have not implemented the Agreement and have not negotiated letters of understanding with the United States for rules of origin changes, the provision grants limited proclamation authority to the President to proclaim changes yet to be agreed upon related to rules of origin for articles containing pocketing material, but the President's authority is subject to consultation and layover requirements and Congressional disapproval action. These limitations are considered appropriate given the extraordinary nature of granting open-ended proclamation authority to a President in this sensitive product area.

In addition, the provision provides a technical correction with respect to application of a retroactive effective date for certain liquidations and reliquidations of co-produced products. The provision also creates a reporting requirement for the U.S. Trade Representative's Office on the status of negotiations related to other CAFTA-DR textile changes concerning socks and technical corrections.

Effective Date

The effective date is the date of enactment, and the apparel proclamation authority extends until December 31, 2007.