# DESCRIPTION OF CHAIRMAN'S AMENDMENT IN THE NATURE OF THE SUBSTITUTE TO H.R. 3669, THE "EMPLOYEE RETIREMENT SAVINGS BILL OF RIGHTS"

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## INTRODUCTION

The House Committee on Ways and Means has scheduled a markup of H.R. 3669, the "Employee Retirement Savings Bill of Rights," for March 14, 2002. This document,[1] prepared by the staff of the Joint Committee on Taxation, provides a description of the Chairman's amendment in the nature of a substitute to H.R. 3669.

[1] This document may be cited as follows: Joint Committee on Taxation, *Description of Chairman's Amendment in the Nature of the Substitute to H.R. 3669, the "Employee Retirement Savings Bill of Rights"* (JCX-15-02), March 13, 2002.

## TITLE I: DEFINED CONTRIBUTION PLAN PROTECTIONS

### A. Excise Tax on Failure to Provide Investment Education Notices to Participants

#### Present Law

Present law does not require that participants be given specific information relating to investment education.

#### Description of Proposal

Under the proposal, in the case of a plan that permits a participant to direct the investment of his or her account, or a plan (including a qualified defined benefit plan) under which a participant's accrued benefit depends on hypothetical investments directed by the participant, applicable individuals generally would have to be provided with investment education notices on a quarterly basis and to a participant upon enrollment in the plan.[2] Applicable individuals would include plan participants, alternate payees under a qualified domestic relations order, and beneficiaries of a deceased participant or alternate payee. The notice requirement would not apply to one-person plans.[3]

The investment education notice would be required to contain an explanation, for the long-term retirement security of participants and beneficiaries, of generally accepted investment principles, including risk management and diversification, and a discussion of the risk of holding substantial portions of a portfolio in securities of any one entity, such as employer securities.

The notice would have to be written in a manner calculated to be understood by the average plan participant and provide sufficient information (as determined under Treasury guidance) to allow recipients to understand the notice. The notice would be required to be in writing and could be provided in electronic or other form to the extent that such form is reasonably accessible to the applicable individual.

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[2] The right to direct investments would include the right of a applicable individual in an employee stock ownership plan to direct the investment of a portion of his or her account under present law and the right of an applicable individual to direct the plan to divest the individual's account of employer securities as provided under another provision of the proposal.

[3] A one-person plan would be a plan that (1) on the first day of the plan year, covered only the employer (and the employer's spouse) and the employer owned the entire business (whether or not incorporated) or covered only one or more partners (and their spouses) in a business partnership, (2) meets the minimum coverage requirements without being combined with any other plan that covers employees of the business, (3) does not provide benefits to anyone except the employer (and the employer's spouse) or the partners (and their spouses), (4) does not cover a business that is a member of an affiliated service group, a controlled group of corporations, or a group of corporations under common control, and (5) does not cover a business that leases employees.

In the case of a failure to comply with the notice requirement, an excise tax of $100 for each applicable individual with respect to whom the failure occurred would generally be imposed on the employer.[4] If the employer exercised reasonable diligence to meet the notice requirements, the total excise tax imposed during a taxable year would not exceed $500,000. No tax would be imposed with respect to a failure if the employer exercised reasonable diligence to comply and the failure was corrected within 30 days. In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

## Effective Date

The proposal would be effective for plan years beginning after December 31, 2002. Within 120 days after enactment (or by January 1, 2003, if earlier), the Secretary of the Treasury, in consultation with the Secretary of Labor, would be required to issue guidance and model notices that comply with the new requirements.

[4] In the case of a multiemployer plan, the excise tax would be imposed on the plan.

## B. Excise Tax on Failure to Provide Notice to Participants of Transaction Restriction Periods

### Present Law

Present law does not require that participants be given advance notice of temporary periods during which the ability to direct investments or to obtain loans or distributions from the plan is restricted.

### Description of Proposal

#### In general

Under the proposal, a qualified retirement plan or annuity, a tax-sheltered annuity plan, or an eligible deferred compensation plan of a governmental employer would be required to provide 30 days advance notice of a transaction restriction period to applicable individuals to whom the transaction restriction period applied. Applicable individuals would include plan participants, alternate payees under a qualified domestic relations order, and beneficiaries of a deceased participant or alternate payee.

The notice requirement would apply to a plan that maintains accounts for participants or a plan under which a participant's accrued benefit depends in whole or in part on hypothetical investments directed by the participant. The notice requirement would not apply to one-person plans (as defined under the preceding proposal).

#### Definition of transaction restriction period

A transaction restriction period would mean a temporary or indefinite period of at least three consecutive days during which the rights otherwise provided under the plan to one or more applicable individuals to direct investments, or obtain loans or distributions from the plan, were substantially reduced (other than because of the application of securities laws or other circumstances specified in regulations). For this purpose, rights would be treated as substantially reduced with respect to directing investments out of employer securities if rights were significantly restricted for at least three consecutive business days. In the case of a publicly-traded security, "business day" would mean any day on which the security may be traded on its principal market, and, in the case of a security that is not publicly traded, "business day" would mean any calendar day.

It is intended that the determination of whether an individual's right to direct investments or obtain loans or distributions from the plan were substantially reduced, or whether the right to direct investments out of employer securities were significantly restricted, would be determined by reference to the normal rights and procedures provided under the plan. For example, in the case of a plan that normally permits participants to direct the investment of their accounts, a substantial reduction in their right to do so could result in a transaction restriction period. On the other hand, a transaction restriction period would not result merely because a plan normally does not permit participants (or permits only certain participants) to direct investments or normally permits changes in investments only during certain periods. In addition, if a plan normally limits

a participant's ability to make investment changes, or obtain a loan or a distribution, for a certain period in connection with a qualified domestic relations order with respect to the participant's account, that limitation would not of itself result in a transaction restriction period.

**Timing of notice**

Notice of a transaction restriction period would generally have to be provided at least 30 days before the beginning of the period. In the case of a transaction restriction period resulting from an unforeseeable event, the notice would have to be provided as soon as reasonably practicable after the event.

If there is the possibility of a transaction restriction period in connection with a major corporate disposition by a corporation maintaining the plan, the notice must be provided at least 30 days before the date of the disposition unless the plan administrator has a substantial basis to believe that no transaction restriction period will occur. If notice is provided at least 30 days before the disposition, no other notice would be required if the transaction restriction period begins within 30 days after the disposition. A "major corporate disposition" would mean the disposition of substantially all of the stock of the corporation, or a subsidiary thereof, or the disposition of substantially all of the assets used in a trade or business of the corporation or subsidiary. Similar rules would apply in the case of an entity that is not a corporation.

**Form of notice**

Notice of a transaction restriction period would have to be written in a manner calculated to be understood by the average plan participant and provide sufficient information (as determined under Treasury guidance) to allow the recipients to understand the timing and effect of the transaction restriction period. The notice would be required to be provided in writing and could be provided in electronic or other form to the extent that such form is reasonably accessible to the applicable individual.

**Excise tax**

In the case of a failure to comply with the notice requirement, an excise tax of $100 for each applicable individual with respect to whom the failure occurred would generally be imposed on the employer.[5] If the employer exercised reasonable diligence to meet the notice requirements, the total excise tax imposed during a taxable year would not exceed $500,000. No tax would be imposed with respect to a failure if the employer exercised reasonable diligence to comply and the failure were corrected within 30 days (and before the beginning of the transaction restriction period). In the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury would be authorized to waive the excise tax to the extent that the payment of the tax would be excessive or otherwise inequitable relative to the failure involved.

[5] In the case of a multiemployer plan, the excise tax would be imposed on the plan.

## Effective Date

The proposal would be effective for plan years beginning after December 31, 2002. The Secretary of the Treasury, in consultation with the Secretary of Labor, would be required to issue guidance for carrying out the new notice requirements within 120 days after enactment. Guidance concerning a reduction of rights relating to the direction of investments out of employer securities would be required to be issued by November 1, 2002 (or within 60 days after enactment, if later).

## C. Diversification Requirements for Defined Contribution Plans That Hold Employer Securities

### Present Law

#### In general

Whether and the extent to which present law places limits on defined contribution plan investment in employer securities depends on the type of plan.

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

Under the Internal Revenue 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. The diversification requirement applies to a participant for six years, starting with the year in which the individual firsts meets the eligibility requirements (i.e., age 55 and 10 years of participation). The participant must be allowed to elect to diversify up to 25 percent of the participant's account (50 percent in the sixth year), reduced by the portion of the account diversified in prior years.

The participant must be given 90 days after the end of each plan year in the election period to make the election to diversify. In the case of participants who elect to diversify, the plan satisfies the diversification requirement if (1) the plan distributes the applicable amount to the participant within 90 days after the election period, (2) the plan offers at least three investment options (not inconsistent with Treasury regulations) and, within 90 days of the election period, invests the applicable amount in accordance with the participant's election, or (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).[6]

#### 10-percent limit on the acquisition of employer securities

ERISA prohibits money purchase pension plans (other than certain plans in existence before the enactment of ERISA) from acquiring employer securities if, after the acquisition, more than 10 percent of the assets of the plan would be invested in employer stock.[7] This 10-percent limitation does not apply to other types of defined contribution plans. Thus, most defined contribution plans, such as profit-sharing plans, stock bonus plans, and ESOPs, are not subject to any limit on the amount of employer securities that can be invested in employer securities. In addition, a fiduciary generally is deemed not to violate the requirement that plan

[6] Code sec. 401(a)(28); IRS Notice 88-56, 1988-1 CB 540, Q&A 16.

[7] This 10-percent limitation also applies to defined benefit plans.

assets be diversified with respect to the acquisition or holding of employer securities in such plans.[8]

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

## Description of Proposal

### In general

Under the proposal, defined contribution plans that hold employer securities that are readily tradable on an established securities market would be required to permit applicable individuals to direct that the applicable percentage of employer securities in the individual's account be invested in alternative investments. In order to satisfy this diversification requirement, applicable individuals would have to be given a choice of at least three investment options (not inconsistent with regulations prescribed by the Secretary) other than employer securities. In addition, applicable individuals would have to be given the right to direct the reinvestment of employer securities in alternative investments not less frequently than quarterly. The definition of applicable individual and applicable percentage would depend on the type of contribution involved. In all cases, the election applies only to the extent that the amount attributable to the applicable percentage exceeds the amount to which a prior election under the ESOP diversification rules or under the proposal applies.[9]

The diversification requirement would not apply to ESOPs unless the ESOP holds elective deferrals, employee after-tax contributions, matching contributions, or other contributions used to satisfy the special nondiscrimination tests for elective deferrals (i.e., qualified nonelective contributions and nonelective contributions under safe harbor plans). The present-law ESOP diversification rules would not apply to employer securities which are readily tradable on an established securities market and subject to the requirements of the proposal.

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

[9] As under the present-law ESOP diversification rules, it would be intended that the portion of a plan that is diversified pursuant to the provision would not be considered to be part of the ESOP and therefore would not be subject to the rules applicable to ESOPs. This same principle would apply to the extent the employer provides for more diversification than required under the proposal.

**Elective deferrals and other employee contributions**

In the case of elective deferrals under a qualified cash or deferred arrangement and employee after-tax contributions, an applicable individual would mean (1) any plan participant, (2) any beneficiary who is an alternate payee under a qualified domestic relations order, and (3) any beneficiary of a deceased participant or alternate payee.

With respect to elective deferrals (and earnings thereon) treated as a separate plan for purposes of the ERISA 10-percent limitation on the acquisition of employer securities, the applicable percentage would be 100 percent.[10] With respect to other elective deferrals and employee contributions (and earnings thereon), the applicable percentage would be as follows:

**Table 1--Applicable Percentage for Elective Deferrals not Treated as Separate Plan under ERISA**

| Plan years beginning in: | Applicable percentage: |
|---|---|
| 2003..... | Greater of amount that would be required under present-law ESOP diversification rule or 20 percent |
| 2004..... | Greater of amount the would be required under present-law ESOP diversification rule or 40 percent |
| 2005..... | 60 percent |
| 2006..... | 80 percent |
| 2007 or thereafter..... | 100 percent |

**Matching and other contributions taken into account in applying nondiscrimination rules applicable to elective deferrals**

In the case of matching contributions and employer contributions used to satisfy the special nondiscrimination test applicable to elective deferrals (i.e., qualified nonelective contributions and nonelective contributions under the 401(k) safe harbor rules) an applicable individual would mean (1) any plan participant with three years of service[11], (2) any beneficiary with respect to a participant described in (1) who is an alternate payee under an applicable qualified domestic relations order, and (3) any beneficiary of a deceased participant described in (1) or alternate payee described in (2).

[10] The determination of whether elective deferrals are treated as a separate plan and thus are subject to the 100 percent diversification rule (rather than the phase-in) would be made on the date of enactment.

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

With respect to such matching contributions and contributions used to satisfy the special nondiscrimination test applicable to elective deferrals that are *not* part of an ESOP, the applicable percentage would be as follows:

**Table 2--Applicable Percentage for Matching and Other Contributions Used to Satisfy 401(k) Nondiscrimination Rules that are not part of an ESOP**

| Plan years beginning in: | Applicable percentage: |
|---|---|
| 2003..... | 20 percent |
| 2004..... | 40 percent |
| 2005..... | 60 percent |
| 2006..... | 80 percent |
| 2007 and thereafter..... | 100 percent |

In the case of matching contributions and other contributions used to satisfy the special 401(k) nondiscrimination rules that are part of an ESOP, the applicable percentage would be as in Table 2 above, except that for plan years beginning in 2003 and 2004, the applicable percentage would not be less than the amount required under the present-law ESOP diversification requirement.

**Other employer contributions**

In the case of employer contributions other than those described above (i.e., contributions unrelated to employee elective deferrals or employee contributions) an applicable individual would mean (1) any plan participant with five years of service[12], (2) any beneficiary with respect to a participant described in (1) who is an alternate payee under an applicable qualified domestic relations order, and (3) any beneficiary of a deceased participant described in (1) or alternate payee described in (2).

The applicable percentage for such contributions would be the same as for matching contributions. Thus, in the case of contributions that are not part of an ESOP, the applicable percentage would be as described in Table 2. In addition, in the case of such contributions that are part of an ESOP, the applicable percentage would be as described in Table 2, except that for plan years beginning in 2003 and 2004, the applicable percentage would not be less than the amount required under the present-law ESOP diversification requirement.

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

## Effective Date

The provision generally would be effective with respect to plan years beginning after December 31, 2002. The provision would not apply to employer securities held by an ESOP that are not subject to the present-law diversification requirement, i.e., stock acquired before January 1, 1987.

## D. Employer-Provided Qualified Retirement Planning Services

### Present Law

Under present law, certain employer-provided fringe benefits are excludable from gross income and wages for employment tax purposes.[13] These excludable fringe benefits include qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified employer plan. A qualified employer plan includes a qualified retirement plan or annuity, a tax-sheltered annuity, a simplified employee pension, a SIMPLE retirement account, or a governmental plan, including an eligible deferred compensation plan maintained by a governmental employer.

Qualified retirement planning services are retirement planning advice and information. The exclusion is not limited to information regarding the qualified employer plan, and, thus, for example, applies to advice and information regarding retirement income planning for an individual and his or her spouse and how the employer's plan fits into the individual's overall retirement income plan. On the other hand, the exclusion does not apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

The exclusion does not apply with respect to highly compensated employees unless the services are available on substantially the same terms to each member of the group of employees normally provided education and information regarding the employer's qualified plan.

### Description of Proposal

The proposal would permit employers to offer employees a choice between cash compensation or eligible qualified retirement planning services. The proposal would only apply to qualified retirement planning services provided by a qualified investment advisor. It is intended that qualified investment advisors will be certified and regulated under applicable laws and regulations. Under the proposal, no amount would be includible in gross income or wages merely because the employee is offered the choice of cash in lieu of eligible qualified retirement planning services. Also, no amount would be includible in income or wages merely because the employee is offered a choice among eligible qualified retirement planning services. The amount of cash offered would be includible in income and wages only to the extent the employee elects cash. The exclusion would not apply to highly compensated employees unless the salary reduction option is available on substantially the same terms to all employees normally provided education and information about the plan.

Under the proposal, salary reduction amounts used to provide eligible qualified retirement planning services would be treated for pension plan purposes the same as other salary reduction contributions. Thus, such amounts would be included for purposes of applying the limits on contributions and benefits, and an employer would be able to elect whether or not to include such amounts in compensation for nondiscrimination testing.

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[13] Secs. 132 and 3121(a)(20).

## Effective Date

The proposal would apply to taxable years beginning after December 31, 2002.

## E. Special Rules

### Present Law

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

### Description of Proposal

**Delayed effective date for collectively bargained plans**

The proposal provides a delayed effective date for collectively bargained plans for certain provisions relating to retirement savings. Under the proposal, in the case of a plan maintained pursuant to one or more collective bargaining agreements ratified on or before the date of enactment, the amendments made by proposal relating to notices and diversification would be applied beginning with the first plan year beginning on or after the earlier of:

(1) The later of: (a) January 1, 2004, or (b) 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) January 1, 2005.

**Time for making plan amendments**

If any of the provisions of the proposal relating to retirement savings require an amendment to the plan, such plan amendment would not be required to be made before the first plan year beginning on or after January 1, 2005, if during the period after the provisions of the proposal take effect and before such first plan year the plan is operated in accordance with the provisions of the bill and the plan amendment applies retroactively.

## TITLE II: OTHER TAX PROVISIONS RELATING TO PENSIONS

### A. Amendments to Retirement Protection Act of 1994

#### Present Law

Under present law, defined benefit pension plans are required to meet certain minimum funding rules. In some cases, additional contributions are required if a 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. Quarterly minimum funding contributions are required in the case of underfunded plans.

The Pension Benefit Guaranty Corporation ("PBGC") insures benefits under most defined benefit pension plans in the event the plan is terminated with insufficient assets to pay for plan benefits. The PBGC is funded in part by a flat-rate premium per plan participant, and a variable rate premium based on plan underfunding.

Under present law, 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 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 2005 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 2005, the relief from the minimum funding requirements applies only if certain specified contributions are made.

For plan years beginning after 2004 and before 2010, the funded current liability percentage 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 applies for the plan year beginning in 2005, 2006, 2007, and 2008 only if contributions to the plan equal at least the expected increase in current liability due to benefits accruing during the plan year.

#### Description of Proposal

The proposal modifies the special funding rule for plans sponsored by a company engaged primarily in interurban or interstate passenger bus service by making the rule permanent.

In addition, the proposal modifies the rule by providing that (1) the funded current liability percentage of a plan to which the rule applies is treated as not less than 90 percent for purposes of the minimum funding rules applicable to underfunded plans, and (2) the funded current liability percentage of a plan to which the rule applies is treated as not less than 100 percent for purposes of the quarterly contribution requirement.

## Effective Date

The provision is effective with respect to plan years beginning after December 31, 2001.

## B. Pension Plan Reporting Simplification

### Present Law

A plan administrator of a pension, annuity, stock bonus, profit-sharing or other funded plan of deferred compensation generally must file with the Secretary of the Treasury an annual return for each plan year containing certain information with respect to the qualification, financial condition, and operation of the plan. Title I of ERISA also may require the plan administrator to file annual reports concerning the plan with the Department of Labor and the Pension Benefit Guaranty Corporation ("PBGC"). The plan administrator must use the Form 5500 series as the format for the required annual return.[14] The Form 5500 series annual return/report, which consists of a primary form and various schedules, includes the information required to be filed with all three agencies. The plan administrator satisfies the reporting requirement with respect to each agency by filing the Form 5500 series annual return/report with the Department of Labor, which forwards the form to the Internal Revenue Service and the PBGC.

The Form 5500 series consists of 2 different forms: Form 5500 and Form 5500-EZ. Form 5500 is the more comprehensive of the forms and requires the most detailed financial information. A plan administrator generally may file Form 5500-EZ, which consists of only one page, if (1) the only participants in the plan are the sole owner of a business that maintains the plan (and such owner's spouse), or partners in a partnership that maintains the plan (and such partners' spouses), (2) the plan is not aggregated with another plan in order to satisfy the minimum coverage requirements of section 410(b), (3) the employer is not a member of a related group of employers, and (4) the employer does not receive the services of leased employees. If the plan satisfies the eligibility requirements for Form 5500-EZ and the total value of the plan assets as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed $100,000, the plan administrator is not required to file a return.

With respect to a plan that does not satisfy the eligibility requirements for Form 5500-EZ, the characteristics and the size of the plan determine the amount of detailed financial information that the plan administrator must provide on Form 5500. If the plan has more than 100 participants at the beginning of the plan year, the plan administrator generally must provide more information.

### Description of Proposal

The Secretary of the Treasury and the Secretary of Labor would be directed to modify the annual return filing requirements with respect to plans that satisfy the eligibility requirements for Form 5500-EZ (referred to as 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 did not exceed $250,000, the plan administrator would not be required to file a return. In addition, the proposal would direct the Secretary of the Treasury and the Secretary of Labor to provide simplified reporting

[14] Treas. Reg. sec. 301.6058-1(a).

requirements for plan years beginning after December 31, 2003, certain plans with fewer than 25 employees.

## Effective Date

The proposal relating to one-participant plans would be effective for plans beginning on or after January 1, 2002. The proposal relating to simplified reporting for plans with fewer than 25 employees would be effective on date of enactment.

## C. Improvement to Employee Plans Compliance Resolution System

### Present Law

A retirement plan that is intended to be a tax-qualified plan provides retirement benefits on a tax-favored basis if the plan satisfies all of the requirements of section 401(a). Similarly, an annuity that is intended to be a tax-sheltered annuity provides retirement benefits on a tax-favored basis if the program satisfies all of the requirements of section 403(b). Failure to satisfy all of the applicable requirements of section 401(a) or section 403(b) may disqualify a plan or annuity for the intended tax-favored treatment.

The Internal Revenue Service ("IRS") has established the Employee Plans Compliance Resolution System ("EPCRS"), which is a comprehensive system of correction programs for sponsors of retirement plans and annuities that are intended, but have failed, to satisfy the requirements of section 401(a), section 403(a), or section 403(b), as applicable.[15] EPCRS permits employers to correct compliance failures and continue to provide their employees with retirement benefits on a tax-favored basis.

The IRS has designed EPCRS to (1) encourage operational and formal compliance, (2) promote voluntary and timely correction of compliance failures, (3) provide sanctions for compliance failures identified on audit that are reasonable in light of the nature, extent, and severity of the violation, (4) provide consistent and uniform administration of the correction programs, and (5) permit employers to rely on the availability of EPCRS in taking corrective actions to maintain the tax-favored status of their retirement plans and annuities.

The basic elements of the programs that comprise EPCRS are self-correction, voluntary correction with IRS approval, and correction on audit. The Self-Correction Program ("SCP") generally permits a plan sponsor that has established compliance practices to correct certain insignificant failures at any time (including during an audit), and certain significant failures within a 2-year period, without payment of any fee or sanction. The Voluntary Correction Program ("VCP") program permits an employer, at any time before an audit, to pay a limited fee and receive IRS approval of a correction. For a failure that is discovered on audit and corrected, the Audit Closing Agreement Program ("Audit CAP") provides for a sanction that bears a reasonable relationship to the nature, extent, and severity of the failure and that takes into account the extent to which correction occurred before audit.

The IRS has expressed its intent that EPCRS will be updated and improved periodically in light of experience and comments from those who use it.

### Description of Proposal

The Secretary of the Treasury would be directed to continue to update and improve EPCRS, giving special attention to (1) increasing the awareness and knowledge of small employers concerning the availability and use of EPCRS, (2) taking into account special

[15] Rev. Proc. 2001-17, 2001-7 I.R.B. 589.

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.

The proposal would clarify that the Secretary has the full authority to effectuate the foregoing with respect to EPCRS (or similar program or 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.

**Effective Date**

The proposal would be effective on the date of enactment.

## D. Flexibility in Nondiscrimination, Coverage, and Line Of Business Rules

### Present Law

A plan is not a qualified retirement plan if the contributions or benefits provided under the plan discriminate in favor of highly compensated employees (sec. 401(a)(4)). The applicable Treasury regulations set forth the exclusive rules for determining whether a plan satisfies the nondiscrimination requirement. These regulations state that the form of the plan and the effect of the plan in operation determine whether the plan is nondiscriminatory and that intent is irrelevant.

Similarly, a plan is not a qualified retirement plan if the plan does not benefit a minimum number of employees (sec. 410(b)). A plan satisfies this minimum coverage requirement if and only if it satisfies one of the tests specified in the applicable Treasury regulations. If an employer is treated as operating separate lines of business, the employer may apply the minimum coverage requirements to a plan separately with respect to the employees in each separate line of business (sec. 414(r)). Under a so-called "gateway" requirement, however, the plan must benefit a classification of employees that does not discriminate in favor of highly compensated employees in order for the employer to apply the minimum coverage requirements separately for the employees in each separate line of business. A plan satisfies this gateway requirement only if it satisfies one of the tests specified in the applicable Treasury regulations.

### Description of Proposal

The Secretary of the Treasury would be directed to modify, on or before December 31, 2003, the existing regulations issued under section 414(r) in order to expand (to the extent that the Secretary may determine to be appropriate) the ability of a plan to demonstrate compliance with the line of business requirements based upon the facts and circumstances surrounding the design and operation of the plan, even though the plan is unable to satisfy the mechanical tests currently used to determine compliance.

The Secretary of the Treasury would be directed to provide by regulation applicable to years beginning after December 31, 2003, that a plan would be deemed to satisfy the nondiscrimination requirements of section 401(a)(4) if the plan satisfied the pre-1994 facts and circumstances test, satisfied the conditions prescribed by the Secretary to appropriately limit the availability of such test, and was submitted to the Secretary for a determination of whether it satisfied such test (to the extent provided by the Secretary).

Similarly, a plan would comply with the minimum coverage requirement of section 410(b) if the plan satisfied the pre-1989 coverage rules, was submitted to the Secretary for a determination of whether it satisfied the pre-1989 coverage rules (to the extent provided by the Secretary), and satisfied conditions prescribed by the Secretary by regulation that appropriately limit the availability of the pre-1989 coverage rules.

## Effective Date

The proposal relating to the line of business requirements under section 414(r) would be effective on the date of enactment. The proposal relating to the nondiscrimination requirements under section 401(a)(4) would be effective on the date of enactment, except that any condition of availability prescribed by the Secretary would not be effective before the first year beginning not less than 120 days after the date on which such condition was prescribed. The proposal relating to the minimum coverage requirements under section 410(b) would be effective for years beginning after December 31, 2003, except that any condition of availability prescribed by the Secretary by regulation would not apply before the first year beginning not less than 120 days after the date on which such condition was prescribed.

## E. Extension To All Governmental Plans Of Moratorium On Application Of Certain Nondiscrimination Rules Applicable To State And Local Government Plans

### Present Law

A qualified retirement plan maintained by a State or local government is exempt from the rules concerning nondiscrimination (sec. 401(a)(4)) and minimum participation (sec. 401(a)(26)). All other governmental plans are not exempt from the nondiscrimination and minimum participation rules.

### Description of Proposal

The proposal would exempt all governmental plans (as defined in sec. 414(d)) from the nondiscrimination and minimum participation rules.

### Effective Date

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

## F. Notice and Consent Period Regarding Distributions

### Present Law

Notice and consent requirements apply to certain distributions from qualified retirement plans. These requirements relate to the content and timing of information that a plan must provide to a participant prior to a distribution, and to whether the plan must obtain the participant's consent to the distribution. The nature and extent of the notice and consent requirements applicable to a distribution depend upon the value of the participant's vested accrued benefit and whether the joint and survivor annuity requirements (sec. 417) apply to the participant.

If the present value of the participant's vested accrued benefit exceeds $5,000, the plan may not distribute the participant's benefit without the written consent of the participant. The participant's consent to a distribution is not valid unless the participant has received from the plan a notice that contains a written explanation of (1) the material features and the relative values of the optional forms of benefit available under the plan, (2) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (3) the rules concerning the taxation of a distribution. If the joint and survivor annuity requirements apply to the participant, this notice also must contain a written explanation of (1) the terms and conditions of the qualified joint and survivor annuity ("QJSA"), (2) the participant's right to make, and the effect of, an election to waive the QJSA, (3) the rights of the participant's spouse with respect to a participant's waiver of the QJSA, and (4) the right to make, and the effect of, a revocation of a waiver of the QJSA. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

If the participant's vested accrued benefit does not exceed $5,000, the terms of the plan may provide for distribution without the participant's consent. The plan generally is required, however, to provide to the participant a notice that contains a written explanation of (1) the participant's right, if any, to have the distribution directly transferred to another retirement plan or IRA, and (2) the rules concerning the taxation of a distribution. The plan generally must provide this notice to the participant no less than 30 and no more than 90 days before the date distribution commences.

### Description of Proposal

A qualified retirement plan would be required to provide the applicable distribution notice no less than 30 days and no more than 180 days before the date distribution commences. The Secretary of the Treasury would be directed to modify the applicable regulations to reflect the extension of the notice period to 180 days and to provide that the description of a participant's right, if any, to defer receipt of a distribution shall also describe the consequences of failing to defer such receipt. In the case of a description of such consequences that was made before the date 90 days after the date on which the Secretary of the Treasury issued a safe harbor description, the plan administrator would be required to make a reasonable attempt to comply with the requirements of the proposal.

## Effective Date

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

## G. Reduced PBGC Premiums For Small And New Plans

### Present Law

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

The PBGC guarantee is phased in ratably in the case of plans that have been in effect for less than 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.

### Description of Proposal

**Reduced flat-rate premiums for new plans of small employers**

Under the proposal, for the first five plan years of a new single-employer plan of a small employer, the flat-rate PBGC premium would be $5 per plan participant.

A small employer would be a contributing sponsor that, on the first day of the plan year, had 100 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor would 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) would be taken into account in determining whether the plan was a plan of a small employer.

A new plan would mean a defined benefit plan maintained by a contributing sponsor if, during the 36-month period ending on the date of adoption of the plan, such contributing sponsor (or controlled group member or a predecessor of either) had not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as in the new plan.

**Reduced variable-rate PBGC premium for new plans**

The proposal would provide that the variable-rate premium would be phased in for new defined benefit plans over a six-year period starting with the plan's first plan year. The amount of the variable-rate premium would be a percentage of the variable premium otherwise due, as follows: zero percent of the otherwise applicable variable-rate premium in the first plan year; 20

percent in the second plan year; 40 percent in the third plan year; 60 percent in the fourth plan year; 80 percent in the fifth plan year; and 100 percent in the sixth plan year (and thereafter).

A new defined benefit plan would be defined as described above under the flat-rate premium proposal of the proposal relating to new small employer plans.

**Reduced variable-rate PBGC premium for small plans**

In the case of a plan of a small employer, the variable-rate premium would be no more than $5 multiplied by the number of plan participants in the plan at the end of the preceding plan year. For purposes of the proposal, a small employer would be a contributing sponsor that, on the first day of the plan year, had 25 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor would 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) would be taken into account in determining whether the plan was a plan of a small employer.

## Effective Date

The reduction of the flat-rate premium for new plans of small employers and the reduction of the variable-rate premium for new plans would be effective with respect to plans established after December 31, 2001. The reduction of the variable-rate premium for small plans would be effective with respect to plan years beginning after December 31, 2002.

## H. Authorization for PBGC to Pay Interest On Premium Overpayment Refunds

### Present Law

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

### Description of Proposal

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

### Effective Date

The proposal would be effective with respect to interest accruing for periods beginning not earlier than the date of enactment.

## I. Rules For Substantial Owner Benefits In Terminated Plans

### Present Law

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

### Description of Proposal

The proposal would provide that the 60-month phase-in of guaranteed benefits would apply to a substantial owner with less than 50 percent ownership interest. For a substantial owner with a 50 percent or more ownership interest ("majority owner"), the phase-in would occur over a 10-year period and would depend on the number of years the plan has been in effect. The majority owner's guaranteed benefit would be limited so that it could not be more than the amount phased in over 60 months for other participants. The rules regarding allocation of assets would apply to substantial owners, other than majority owners, in the same manner as other participants.

### Effective Date

The proposal would be effective for plan terminations with respect to which notices of intent to terminate are provided, or for which proceedings for termination are instituted by the PBGC, after December 31, 2002.

## J. Studies

### Present Law

No provision.

### Description of Proposal

**Study on small employer group plans**

The proposal would direct the Secretary of Labor, in consultation with the Secretary of the Treasury, to conduct a study to determine (1) the most appropriate form(s) of pension plans that would be simple to create and easy to maintain by multiple small employers, while providing ready portability of benefits for all participants and beneficiaries, (2) how such arrangements could be established by employer or employee associations, (3) how such arrangements could provide for employees to contribute independent of employer sponsorship, and (4) appropriate methods and strategies for making such pension plan coverage more widely available to American workers.

The Secretary of Labor would be required to consider the adequacy and availability of existing pension plans and the extent to which existing models may be modified to be more accessible to both employees and employers. The Secretary of Labor would be required to issue a report within 18 months, including recommendations for one or more model plans or arrangements as described above which may serve as the basis for appropriate administrative or legislative action.

**Study on effect of legislation**

The proposal would also direct the Secretary of Labor to report to the Committee on Education and the Workforce of the House of Representatives and the Committee on Health, Education, Labor and Pensions of the Senate regarding the effect of the bill and title VI of the Economic Growth and Tax Relief Reconciliation Act of 2001 ("the 2001 Act") on pension coverage, including any change in the extent of pension plan coverage for low and middle-income workers, the levels of pension plan benefits generally, the quality of pension plan coverage generally, workers' access to and participation in pension plans, and retirement security. This report would be required to be submitted no later than five years after the date of enactment.

### Effective Date

The proposal would be effective on the date of enactment.

## K. Interest Rate Range For Additional Funding Requirements

### Present Law

**In general**

ERISA and the Code impose both minimum and maximum[16] funding requirements with respect to defined benefit pension plans. The minimum funding requirements are designed to provide at least a certain level of benefit security by requiring the employer to make certain minimum contributions to the plan. The amount of contributions required for a plan year 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.

**Additional contributions for underfunded plans**

Additional contributions are required under a special funding rule if a single-employer defined benefit pension plan is underfunded.[17] Under the special rule, a plan is considered underfunded for a plan year if the value of the plan assets is less than 90 percent of the plan's current liability.[18] The value of plan assets as a percentage of current liability is the plan's "funded current liability percentage."

If a plan is underfunded, the amount of additional required contributions is based on certain elements, including whether the plan has an unfunded liability related to benefits accrued before 1988 or 1995 or to changes in the mortality table used to determine contributions, and whether the plan provides for unpredictable contingent event benefits (that is, benefits that depend on contingencies that are not reliably and reasonably predictable, such as facility shutdowns or reductions in workforce). However, the amount of additional contributions cannot exceed the amount needed to increase the plan's funded current liability percentage to 100 percent.

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[16] The maximum funding requirement for a defined benefit plan is referred to as the full funding limitation. Additional contributions are not required if a plan has reached the full funding limitation.

[17] Plans with no more than 100 participants on any day in the preceding plan year are not subject to the special funding rule. Plans with more than 100 but not more than 150 participants are generally subject to lower contribution requirements under the special funding rule.

[18] Under an alternative test, a plan is not considered underfunded if (1) the value of the plan assets is at least 80 percent of current liability and (2) the value of the plan assets was at least 90 percent of current liability for each of the two immediately preceding years or each of the second and third immediately preceding years.

**Required interest rate**

In general, a plan's current liability means all liabilities to employees and their beneficiaries under the plan. 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.[19] The permissible range is from 90 percent to 105 percent. As a result of debt reduction, the Department of the Treasury does not currently issue 30-year Treasury securities.

**Timing of plan contributions**

In general, plan contributions required to satisfy the funding rules must be made within 8-1/2 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. The amount of each required installment is 25 percent of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year.[20]

**PBGC premiums**

Because benefits under a defined benefit pension plan may be funded over a period of years, plan assets may not be sufficient to provide the benefits owed under the plan to employees and their beneficiaries if the plan terminates before all benefits are paid. In order to protect employees and their beneficiaries, the Pension Benefit Guaranty Corporation ("PBGC") generally insures the benefits owed under defined benefit pension plans. Employers pay premiums to the PBGC for this insurance coverage.

In the case of an underfunded plan, additional PBGC premiums are required based on the amount of unfunded vested benefits. These premiums are referred to as "variable rate premiums." In determining the amount of unfunded vested benefits, the interest rate used is 85 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the plan year begins.

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[19] The interest rate used under the plan must be consistent with the assumptions which reflect the purchase rates which would be used by insurance companies to satisfy the liabilities under the plan (section 412(b)(5)(B)(iii)(II)).

[20] No additional quarterly contributions are due once the plan's funded current liability percentage for the plan year reaches 100 percent.

**Special interest rate for 2002 and 2003**

Section 405 of the Job Creation and Worker Assistance Act of 2002, Public Law 107-147, enacted March 9, 2002, provides a special interest rate rule applicable in determining the amount of additional contributions for plan years beginning after December 31, 2001, and before January 1, 2004 (the "applicable plan years").[21]

The special rule expands the permissible range of the statutory interest rate used in calculating a plan's current liability for purposes of applying the additional contribution requirements for the applicable plan years. The permissible range is from 90 percent to 120 percent for these years. Use of a higher interest rate under the expanded range will affect the plan's current liability, which may in turn affect the need to make additional contributions and the amount of any additional contributions.

Because the quarterly contributions requirements are based on current liability for the preceding plan year, a special rule is provided for applying these requirements for plan years beginning in 2002 (when the expanded range first applies) and 2004 (when the expanded range no longer applies). In each of those years ("present year"), current liability for the preceding year is redetermined, using the permissible range applicable to the present year. This redetermined current liability will be used for purposes of the plan's funded current liability percentage for the preceding year, which may affect the need to make quarterly contributions and for purposes of determining the amount of any quarterly contributions in the present year, which is based in part on the preceding year.

## Description of Proposal

Under the proposal, the special interest rate rule for 2002 and 2003 would apply also in determining the amount of additional contributions for the 2001 plan year that must be contributed to the plan within 8 ½ months after the end of the plan year (e.g., by September 15, 2002). The proposal would not affect quarterly contributions required to be made for the 2001 plan year.

## Effective Date

The proposal would be effective as if included in section 405 of the Job Creation and Worker Assistance Act of 2002.

[21] Under a related special rule, the interest rate used in determining the amount of unfunded vested benefits for PBGC variable rate premium purposes is increased to 100 percent of the interest rate on 30-year Treasury securities for the month preceding the month in which the applicable plan year begins.

## L. Provisions Relating To Plan Amendments

### Present Law

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

### Description of Proposal

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

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

The Secretary would be authorized to provide exceptions to the relief from the prohibition on reductions in accrued benefits. It would be intended that the Secretary would not permit inappropriate reductions in contributions or benefits that were not directly related to the proposals of the bill or the 2001 Act. For example, it would be intended that a plan that incorporated the section 415 limits by reference could be retroactively amended to impose the section 415 limits in effect before the 2001 Act. On the other hand, suppose a plan incorporated the section 401(a)(17) limit on compensation by reference and provided for an employer contribution of 3 percent of compensation. It would be expected that the Secretary would provide that the plan could not be amended retroactively to reduce the contribution percentage for those participants not affected by the section 401(a)(17) limit, even though the reduction would result in the same dollar level of contributions for some participants because of the increase in compensation taken into account under the plan as a result of the increase in the section 401(a)(17) limit under the 2001 Act. As another example, suppose that under present law a plan was top-heavy and therefore a minimum benefit was required under the plan, and that

under the proposals of the 2001 Act, the plan would not be considered to be top heavy. It would be expected that the Secretary would generally permit plans to be retroactively amended to reflect the new top-heavy proposals of the 2001 Act.

## Effective Date

The proposal would be effective on the date of enactment.

## TITLE III: STOCK OPTIONS

### A. Exclusion of Incentive Stock Options and Employee Stock Purchase Plan Stock Options from Wages

**Present Law**

Generally, when an employee exercises a compensatory option on employer stock, the difference between the option price and the fair market value of the stock (i.e., the "spread") is includible in income as compensation. In the case of an incentive stock option or an option to purchase stock under an employee stock purchase plan (collectively referred to as "statutory stock options"), the spread is not included in income at the time of exercise.[22]

If a statutory holding period requirement is satisfied with respect to stock acquired through the exercise of a statutory stock option, the spread, and any additional appreciation, will be taxed as capital gain upon disposition of such stock. Compensation income is recognized, however, if there is a disqualifying disposition (i.e., if the statutory holding period is not satisfied) of stock acquired pursuant to the exercise of a statutory stock option. Compensation income is also recognized in the case of a qualifying disposition of employee stock purchase plan stock if the option price reflected a discount.[23] Even though compensation income is recognized upon such dispositions, employers are generally not required to withhold income taxes.

Federal Insurance Contribution Act ("FICA") and Federal Unemployment Tax Act ("FUTA") taxes are generally imposed in an amount equal to a percentage of wages paid by the employer with respect to employment.[24] The applicable Code provisions[25] do not provide an exception from FICA and FUTA taxes for wages paid to an employee arising from the exercise of a statutory stock option, i.e., for the excess of the fair market value of the stock at the time of exercise over the amount paid for the stock by the individual.

In 1971, the Internal Revenue Service issued a revenue ruling addressing the withholding obligations of a company upon the exercise of a qualified stock option (the predecessor to incentive stock options).[26] The ruling concluded that there is no payment of wages for purposes of FICA, FUTA, or income tax withholding at the time of exercise. There has been uncertainty

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[22] Sec. 421.

[23] The amount that must be included in income is the lesser of (1) the excess of the fair market value of the stock at the time of disposition over the amount paid for the stock, or (2) the excess of the fair market value of the stock at the time the option was granted over the option price.

[24] Secs. 3101, 3111 and 3301.

[25] Secs. 3121 and 3306.

[26] Rev. Rul. 71-52, 1971-1 C.B. 278.

as to the extent to which a similar result applies on exercise of an incentive stock option or employee stock purchase plan.

In January 2001, the Internal Revenue Service issued notice of its intent to clarify, through future guidance, the application of FICA, FUTA, and Federal income tax withholding to statutory stock options.[27] The notice provided that in the case of a statutory stock option exercised before January 1, 2003, the IRS would not assess FICA or FUTA taxes upon the exercise of the option and would not treat the disposition of stock acquired pursuant to the exercise of a statutory stock option as subject to Federal income tax withholding. The notice also provided that the Internal Revenue Service would honor claims for refunds of FICA and FUTA taxes paid. The notice also concluded that Revenue Ruling 71-52 is obsolete and that its holding does not apply to the exercise of statutory stock options.

Proposed Treasury regulations issued in November 2001, provide that the payment of FICA and FUTA taxes upon the exercise of statutory stock options will apply to the exercise of statutory stock options on or after January 1, 2003. Federal income tax withholding is not required under the proposed regulations. Consistent with Notice 2001-14, the Internal Revenue Service will not assess FICA or FUTA taxes upon the exercise of a statutory stock option before 2003.

## Description of Proposal

The proposal would provide specific exclusions from FICA and FUTA wages for remuneration on account of the transfer of stock pursuant to the exercise of an incentive stock option or under an employee stock purchase plan, or any disposition of such stock. Thus, FICA and FUTA taxes would not apply upon the exercise of a statutory stock option.[28] The proposal would also provide that such remuneration is not taken into account for purposes of determining Social Security benefits.

Additionally, the proposal would provide that Federal income tax withholding is not required on a disqualifying disposition, nor when compensation is recognized in connection with an employee stock purchase plan discount. Present law reporting requirements would continue to apply.

## Effective Date

The proposal would apply to stock acquired pursuant to statutory stock options exercised after the date of enactment. It is expected that Treasury and the Internal Revenue Service will not attempt to collect FICA or FUTA taxes attributable to exercises of statutory stock options before the effective date.

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[27] Notice 2001-14, 2001-6 I.R.B. 516.

[28] The proposal would provide a similar exclusion for wages under the Railroad Retirement Tax Act.

## TITLE IV: SOCIAL SECURITY HELD HARMLESS

### A. No Impact on Social Security Trust Funds

#### Present Law

Present law provides for the transfer of Social Security taxes and certain self-employment taxes to the Social Security trust fund. In addition, the income tax collected with respect to a portion of Social Security benefits included in gross income is transferred to the Social Security trust fund.

#### Explanation of Proposal

The proposal would provide that the Secretary is to annually estimate the impact of the bill on the income and balances of the Social Security trust fund. Under the proposal, if the Secretary determines that the bill has a negative impact on the income and balances of the fund, then the Secretary is to transfer from the general revenues of the Federal government an amount sufficient so as to ensure that the income and balances of the Social Security trust funds are not reduced as a result of the bill. Such transfers are to be made not less frequently than quarterly.

The proposal would provide that the provisions of the bill are not to be construed as an amendment of title II of the Social Security Act.

#### Effective Date

The proposal would be effective on the date of enactment.