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RESTORING EARNINGS TO LIFT INDIVIDUALS AND EMPOWER FAMILIES (RELIEF) ACT OF 2001

TECHNICAL EXPLANATION OF PROVISIONS
APPROVED BY THE COMMITTEE ON MAY 15, 2001

COMMITTEE ON FINANCE
UNITED STATES SENATE

CHARLES E. GRASSLEY, *Chairman*

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I. MARGINAL TAX RATE REDUCTION

A. INDIVIDUAL INCOME TAX RATE STRUCTURE

(Sec. 101 of the bill and Sec. 1 of the Code)

PRESENT LAW

Under the Federal individual income tax system, an individual who is a citizen or a resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income. This tax liability is then reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

For 2001, the regular income tax rate schedules for individuals are shown in Table 1, below. The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

TABLE 1.—INDIVIDUAL REGULAR INCOME TAX RATES FOR 2001

If taxable income is over	But not over	Then regular income tax equals
		Single individuals
$0	$27,050	15 percent of taxable income.
$27,050	65,550	$4,057.50, plus 28% of the amount over $27,050.
$65,550	136,750	$14,837.50, plus 31% of the amount over $65,550.
$136,750	297,350	$36,909.50, plus 36% of the amount over $136,750.
Over $297,350	....	$94,725.50, plus 39.6% of the amount over $297,350.
		Heads of households
$0	36,250	15 percent of taxable income.
$36,250	93,650	$5,437.50, plus 28% of the amount over $36,250.
$93,650	151,650	$21,509.50, plus 31% of the amount over $93,650.

TABLE 1.—INDIVIDUAL REGULAR INCOME TAX RATES FOR 2001—Continued

If taxable income is over	But not over	Then regular income tax equals
$151,650	297,350	$39,489.50, plus 36% of the amount over $151,650.
Over $297,350		$91,941.50, plus 39.6% of the amount over $297,350.
Married individuals filing joint returns		
$0	45,200	15 percent of taxable income.
$45,200	109,250	$6,780.00, plus 28% of the amount over $45,200.
$109,250	166,500	$24,714.50, plus 31% of the amount over $109,250.
$166,500	297,350	$42,461.50, plus 36% of the amount over $166,500.
Over $297,350		$89,567.50, plus 39.6% of the amount over $297,350

REASONS FOR CHANGE

The Committee believes that providing tax relief to the American people is appropriate for a number of reasons. The Congressional Budget Office ("CBO") projects budget surpluses of $5.6 trillion over the next 10 fiscal years (2001–2010). Federal revenues have been rising as a share of the gross domestic product ("GDP"). CBO projects that, during the fiscal year 2001–2010 period, Federal revenues will be more than 20 percent of the GDP annually. By contrast, during the early 1990's, Federal revenues generally were only 17–18 percent of the GDP. Individual income taxes account for most of the recent rise in revenues as a percentage of GDP. Federal individual income tax revenues rose to over 10 percent of GDP in fiscal year 2000 for the first time in history and are projected by the CBO to exceed 10 percent of GDP for each of the fiscal years 2001–2010. The CBO projects that the growth of Federal revenues will, for fiscal year 2001, outstrip the growth of GDP for the ninth consecutive year. Moreover, the CBO states that "[t]he most significant source of the growth of income taxes relative to GDP was the increase in the effective tax rate."[1]

Taking these things into account, the Committee believes that at least a portion of the projected budget surpluses should be returned to the taxpayers who are paying Federal income taxes while still retaining adequate monies to pay down the public debt, fund priorities such as education and defense, and secure the future of Social Security and Medicare. The Committee believes that this bill provides the appropriate level of tax relief without threatening funding for other national priorities.

The Committee bill provides immediate tax relief to American taxpayers in the form of a new rate bracket for the first $6,000 of taxable income for single individuals and the first $12,000 of taxable income for married couples filing a joint return. This new 10-percent rate bracket is effective this year. The Committee believes that such immediate tax relief may encourage short-term growth in the economy by providing individuals with additional cash to spend. Also, the new 10-percent rate bracket in the Committee bill delivers more benefit as a percentage of income to low-income taxpayers than high-income taxpayers.

The Committee bill will provide tax relief to more than 100 million income tax returns of individuals, including at least 16 million returns of individuals of owners of businesses (sole proprietorships,

[1] Congressional Budget Office, Congress of the United States, The Budget and Economic Outlook: Fiscal Years 2002–2011, January 2001, at 56.

partnerships, and S corporations). The Committee believes that this tax cut will lead to increased investment by these businesses, promoting long-term growth and stability in the economy and rewarding the businessmen and women who provide a foundation for our country's success.

The Committee also believes that it is appropriate to repeal the 10-percent surtax imposed in 1993 to cut the deficit. This 10-percent surtax on top of the 36-percent rate resulted in a 39.6-percent marginal tax rate for those in the highest income tax bracket. Because the Congressional Budget Office is projecting budget surpluses over the next ten years, the Committee believes that it is appropriate to repeal this deficit-era surtax.

Finally, the Committee believes that the lower rates provided by this bill is a fair means to provide tax relief for all taxpayers.

EXPLANATION OF PROVISION

In general

The bill creates a new 10-percent regular income tax bracket for a portion of taxable income that is currently taxed at 15 percent, effective for taxable years beginning after December 31, 2000. The bill also reduces other regular income tax rates. By 2007, the present-law individual income tax rates of 28 percent, 31 percent, 36 percent and 39.6 percent will be lowered to 25 percent, 28 percent, 33 percent, and 36 percent, respectively.

New low-rate bracket

The bill establishes a new 10-percent regular income tax rate bracket for a portion of taxable income that is currently taxed at 15 percent, as shown in Table 3, below. The taxable income levels for the new 10-percent rate bracket will be adjusted annually for inflation for taxable years beginning after December 31, 2006. The new low-rate bracket for joint returns and head of household returns will be rounded down to the nearest $50. The bracket for single individuals and married individuals filing separately will be one-half the bracket for joint returns (after adjustment for inflation).

The 10-percent rate bracket applies to the first $6,000 of taxable income for single individuals, $10,000 of taxable income for heads of households, and $12,000 for married couples filing joint returns.

Modification of 15-percent bracket

The 15-percent regular income tax bracket is modified to begin at the end of the new low-rate regular income tax bracket. The 15-percent regular income tax bracket ends at the same level as under present law. The bill also makes other changes to the 15-percent rate bracket.[2]

Reduction of other rates

The present-law regular income tax rates of 28 percent, 31 percent, 36 percent, and 39.6 percent are phased-down over six years to 25 percent, 28 percent, 33 percent, and 36 percent, effective for taxable years beginning after December 31, 2001. The taxable in-

[2] See the discussion of marriage penalty relief, below (Sec. 302 of the bill).

come levels for the new rates are the same as the taxable income levels that apply under the present-law rates.

Table 2, below, shows the schedule of regular income tax rate reductions.

TABLE 2.—REGULAR INCOME TAX RATE REDUCTIONS

Calendar year	28% rate reduced to	31% rate reduced to	36% rate reduced to	39.6% rate reduced to
2002–2004	27	30	35	38.6
2005–2006	26	29	34	37.6
2007 and later	25	28	33	36%

Projected regular income tax rate schedules under the bill

Table 3, below, shows the projected individual regular income tax rate schedules when the rate reductions are fully phased-in (i.e., for 2007). As under present law, the rate brackets for married taxpayers filing separate returns will be one half the rate brackets for married individuals filing joint returns. In addition, appropriate adjustments will be made to the separate, compressed rate schedule for estate and trusts.

TABLE 3.—INDIVIDUAL REGULAR INCOME TAX RATES FOR 2007 (PROJECTED)

If taxable income is	But not over	Then regular income tax equals
Single individuals		
$0	$6,150	10 % of taxable income.
$6,150	31,700	$615, plus 15 % of the amount over $6,150.
$31,700	76,800	$4,447.50, plus 25% of the amount over $31,700.
$76,800	160,250	$15,722.50 plus 28% of the amount over $76,800.
$160,250	348,350	$39,088.50 plus 33% of the amount over $160,250.
Over $348,350		$101,161.50, plus 36% of the amount over $348,350.
Heads of households		
$0	10,250	10 % of taxable income.
$10,250	42,500	$1,025, plus 15% of the amount over $10,250.
$42,500	109,700	$5,862.50, plus 25% of the amount over $42,500.
$109,700	177,650	$22,662.50, plus 28% of the amount over $109,700.
$177,650	348,350	$41,688.50, plus 33% of the amount over $177,650.
Over $348,350		$98,019.50, plus 36% of the amount over $348,350.
Married individuals filing joint returns		
$0	12,300	10 % of taxable income.
$12,300	[3] 57,050	$1,230, plus 15% of the amount over $12,300.
$57,050	128,000	$7,942.50, plus 25% of the amount over $57,050.
$128,000	195,050	$25,680, plus 28% of the amount over $128,000.
$195,050	348,350	$44,454, plus 33% of the amount over $195,050.
Over $348,350		$95,043, plus 36% of the amount over $348,350.

[3] The end point of the 15-percent rate bracket for married individuals filing joint returns also reflects the phase-in of the increase in the size of the 15-percent bracket in section 302 of the bill, below.

Revised wage withholding for 2001

Under present law, the Secretary of the Treasury is authorized to prescribe appropriate income tax withholding tables or computational procedures for the withholding of income taxes from wages paid by employers. The Secretary is expected to make appropriate revisions to the wage withholding tables to reflect the rate reduction for calendar year 2001 as expeditiously as possible.

EFFECTIVE DATE

The new 10-percent rate bracket is effective for taxable years beginning after December 31, 2000. The reduction in the 28 percent, 31 percent, 36 percent, and 39.6 percent rates is phased-in beginning in taxable years beginning after December 31, 2001.

B. Increase Starting Point for Phase-Out of Itemized Deductions (Sec. 102 of the bill and Sec. 68 of the Code)

PRESENT LAW

Itemized deductions

Taxpayers may choose to claim either the basic standard deduction (and additional standard deductions, if applicable) or itemized deductions (subject to certain limitations) for certain expenses incurred during the taxable year. Among these deductible expenses are unreimbursed medical expenses, investment interest, casualty and theft losses, wagering losses, charitable contributions, qualified residence interest, State and local income and property taxes, unreimbursed employee business expenses, and certain other miscellaneous expenses.

Overall limitation on itemized deductions ("Pease" limitation)

Under present law, the total amount of otherwise allowable itemized deductions (other than medical expenses, investment interest, and casualty, theft, or wagering losses) is reduced by three percent of the amount of the taxpayer's adjusted gross income in excess of $132,950 in 2001 ($66,475 for married couples filing separate returns). These amounts are adjusted annually for inflation. In computing this reduction of total itemized deductions, all present-law limitations applicable to such deductions (such as the separate floors) are first applied and, then, the otherwise allowable total amount of itemized deductions is reduced in accordance with this provision. Under this provision, the otherwise allowable itemized deductions may not be reduced by more than 80 percent.

REASONS FOR CHANGE

The Committee believes that the overall limitation on itemized deductions is an unnecessarily complex way to impose taxes and that the "hidden" way in which the limitation raises marginal tax rates undermines respect for the tax laws. The staff of the Joint Committee on Taxation recommended the elimination of certain phase-outs, including the overall limitation on itemized deductions, in a recent study containing recommendations for simplification of the Code.[4] The overall limitation on itemized deductions requires a 10-line worksheet. Moreover, the first line of that worksheet requires the adding up of seven lines from Schedule A of the Form 1040, and the second line requires the adding up of four lines of Schedule A of the Form 1040. The Committee believes that reduc-

[4] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS–3–01), April 2001.

ing the application of the overall limitation on itemized deductions will significantly reduce complexity for affected taxpayers.

EXPLANATION OF PROVISION

The bill increases the starting point of the overall limitation on itemized deductions for all taxpayers (other than married couples filing separate returns) to the starting point of the personal exemption phase-out for married couples filing a joint return. This amount is projected under present law to be $245,500 in 2009. The starting point of the overall limitation on itemized deductions for married couples filing separate returns would continue to be one-half of the amount for other taxpayers.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2008.

C. Repeal of Phase-Out of Personal Exemptions

(Sec. 103 of the bill and Sec. 151(d)(3) of the Code)

PRESENT LAW

In order to determine taxable income, an individual reduces adjusted gross income by any personal exemptions, deductions, and either the applicable standard deduction or itemized deductions. Personal exemptions generally are allowed for the taxpayer, his or her spouse, and any dependents. For 2001, the amount deductible for each personal exemption is $2,900. This amount is adjusted annually for inflation.

Under present law, the deduction for personal exemptions is phased-out ratably for taxpayers with adjusted gross income over certain thresholds. The applicable thresholds for 2001 are $132,950 for single individuals, $199,450 for married individuals filing a joint return, $166,200 for heads of households, and $99,725 for married individuals filing separate returns. These thresholds are adjusted annually for inflation.

The total amount of exemptions that may be claimed by a taxpayer is reduced by two percent for each $2,500 (or portion thereof) by which the taxpayer's adjusted gross income exceeds the applicable threshold. The phase-out rate is two percent for each $1,250 for married taxpayers filing separate returns. Thus, the personal exemptions claimed are phased-out over a $122,500 range ($61,250 for married taxpayers filing separate returns), beginning at the applicable threshold. The size of these phase-out ranges ($122,500/$61,250) is not adjusted for inflation. For 2001, the point at which a taxpayer's personal exemptions are completely phased-out is $255,450 for single individuals, $321,950 for married individuals filing a joint return, $288,700 for heads of households, and $160,975 for married individuals filing separate returns.

REASONS FOR CHANGE

The Committee believes that the personal exemption phase-out is an unnecessarily complex way to impose income taxes and that the "hidden" way in which the phase-out raises marginal tax rates undermines respect for the tax laws. The staff of the Joint Committee on Taxation recommended the elimination of certain phase-outs, including the personal exemption phase-out, in a recent study containing recommendations for simplification of the Code.[5] Furthermore, the Committee believes that the phase-out imposes excessively high effective marginal tax rates on families with children. The repeal of the personal exemption phase-out would restore the full exemption amount to all taxpayers and would simplify the tax laws.

EXPLANATION OF PROVISION

The bill repeals the personal exemption phase-out.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2008.

D. Compliance with Congressional Budget Act

(Secs. 111 and 112 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

[5] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS–3–01), April 2001.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to income tax rates which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to income tax rates which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

II. CHILD TAX CREDIT

A. Increase and Expand the Child Tax Credit

(Sec. 201 of the bill and Sec. 24 of the Code)

PRESENT LAW

Under present law, an individual may claim a $500 tax credit for each qualifying child under the age of 17. In general, a qualifying child is an individual for whom the taxpayer can claim a dependency exemption and who is the taxpayer's son or daughter (or descendent of either), stepson or stepdaughter, or eligible foster child.

The child tax credit is phased-out for individuals with income over certain thresholds. Specifically, the otherwise allowable child tax credit is reduced by $50 for each $1,000 (or fraction thereof) of modified adjusted gross income over $75,000 for single individuals or heads of households, $110,000 for married individuals filing joint returns, and $55,000 for married individuals filing separate returns. Modified adjusted gross income is the taxpayer's total gross income plus certain amounts excluded from gross income (i.e., excluded income of U.S. citizens or residents living abroad (Sec. 911); residents of Guam, American Samoa, and the Northern Mariana Islands (Sec. 931); and residents of Puerto Rico (Sec. 933)). The length of the phase-out range depends on the number of qualifying children. For example, the phase-out range for a single individual with one qualifying child is between $75,000 and $85,000 of modified adjusted gross income. The phase-out range for a single individual with two qualifying children is between $75,000 and $95,000.

The child tax credit is not adjusted annually for inflation.

In general, the child tax credit is nonrefundable. However, for families with three or more qualifying children, the child tax credit is refundable up to the amount by which the taxpayer's Social Security taxes exceed the taxpayer's earned income credit.

Alternative minimum tax liability

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit and, for taxable years beginning after December 31, 2001, the amount of the refundable child credit for families with three or more children. This is known as the alternative minimum tax offset of refundable credits.

Through 2001, an individual generally may reduce his or her tentative alternative minimum tax liability by nonrefundable personal tax credits (such as the $500 child tax credit and the adoption tax credit). For taxable years beginning after December 31, 2001, nonrefundable personal tax credits may not reduce an individual's income tax liability below his or her tentative alternative minimum tax.

REASONS FOR CHANGE

The Committee believes that a tax credit for families with children recognizes the importance of helping families raise children. This provision doubles the child tax credit in order to provide additional tax relief to families to help offset the significant costs of raising a child. Further, the Committee believes that in order to extend some of the benefit of the child credit to families who currently do not benefit, the refundable child credit should be made available to families regardless of the number of children (rather than only families with three or more children). Additionally, the Committee believes that the child credit should be allowed to offset the alternative minimum tax. The Committee bill also repeals the present-law provision reducing the refundable child credit by the amount of the alternative minimum tax in order to ensure that no taxpayer will face an increase in net income tax liability as a result of the interaction of the alternative minimum tax with the regular income tax reductions in the Committee bill.

EXPLANATION OF PROVISION

The bill increases the child tax credit to $1,000, phased-in over eleven years, effective for taxable years beginning after December 31, 2000.

Table 4, below, shows the increase of the child tax credit.

TABLE 4.—INCREASE OF THE CHILD TAX CREDIT

Calendar year	Credit amount per child
2001–2003	$600
2004–2006	700
2007–2009	800
2010	900
2011 and later	1,000

The bill allows the child credit to be claimed against both the regular tax and the alternative minimum tax permanently and repeals the alternative minimum tax offset of refundable credits. Finally, the bill makes the child credit refundable to the extent of 15 percent of the taxpayer's earned income in excess of $10,000.[6] Thus, in 2001, families with earned income of at least $14,000 and one child will get a refundable credit of $600. Families with three or more children are allowed a refundable credit for the amount by which the taxpayer's social security taxes exceed the taxpayer's earned income credit (the present-law rule), if that amount is greater than 15 percent of the taxpayer's earned income in excess of $10,000.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2000.

[6] For these purposes, earned income is defined as under section 32, as amended by this bill.

B. Compliance with Congressional Budget Act

(Secs. 211 and 212 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to the child tax credit which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

RESTORATION OF PROVISIONS

All provisions of, and amendments made by, the bill relating to the child tax credit which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

III. MARRIAGE PENALTY RELIEF PROVISIONS

A. Standard Deduction Marriage Penalty Relief

(Sec. 301 of the bill and Sec. 63 of the Code)

PRESENT LAW

Marriage penalty

A married couple generally is treated as one tax unit that must pay tax on the couple's total taxable income. Although married couples may elect to file separate returns, the rate schedules and other provisions are structured so that filing separate returns usually results in a higher tax than filing a joint return. Other rate schedules apply to single persons and to single heads of households.

A "marriage penalty" exists when the combined tax liability of a married couple filing a joint return is greater than the sum of the tax liabilities of each individual computed as if they were not married. A "marriage bonus" exists when the combined tax liability of a married couple filing a joint return is less than the sum of the tax liabilities of each individual computed as if they were not married.

Basic standard deduction

Taxpayers who do not itemize deductions may choose the basic standard deduction (and additional standard deductions, if applicable),[7] which is subtracted from adjusted gross income ("AGI") in arriving at taxable income. The size of the basic standard deduction varies according to filing status and is adjusted annually for inflation. For 2001, the basic standard deduction amount for single filers is 60 percent of the basic standard deduction amount for married couples filing joint returns. Thus, two unmarried individuals have standard deductions whose sum exceeds the standard deduction for a married couple filing a joint return.

REASONS FOR CHANGE

The Committee is concerned about the inequity that arises when two working single individuals marry and experience a tax increase solely by reason of their marriage. Any attempt to address the marriage tax penalty involves the balancing of several competing principles, including equal tax treatment of married couples with equal incomes, the determination of equitable relative tax burdens of single individuals and married couples with equal incomes, and the goal of simplicity in compliance and administration. The Committee believes that an increase in the standard deduction for married couples filing a joint return in conjunction with the other pro-

[7] Additional standard deductions are allowed with respect to any individual who is elderly (age 65 or over) or blind.

visions of the bill is a responsible reduction of the marriage tax penalty.

EXPLANATION OF PROVISION

The bill increases the basic standard deduction for a married couple filing a joint return to twice the basic standard deduction for an unmarried individual filing a single return. The basic standard deduction for a married taxpayer filing separately will continue to equal one-half of the basic standard deduction for a married couple filing jointly; thus, the basic standard deduction for unmarried individuals filing a single return and for married couples filing separately will be the same. The increase is phased-in over five years beginning in 2006 and would be fully phased-in for 2010 and thereafter. Table 5, below, shows the standard deduction for married couples filing a joint return as a percentage of the standard deduction for single individuals during the phase-in period.

TABLE 5.—PHASE-IN OF INCREASE OF STANDARD DEDUCTION FOR MARRIED COUPLES FILING JOINT RETURNS

Calendar year	Standard deduction for joint returns as percentage of standard deduction for single returns
2006	174
2007	180
2008	187
2009	193
2010 and later	200%

EFFECTIVE DATE

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

B. Expansion of the 15-Percent Rate Bracket For Married Couples Filing Joint Returns

(Sec. 302 of the bill and Sec. 1 of the Code)

PRESENT LAW

In general

Under the Federal individual income tax system, an individual who is a citizen or resident of the United States generally is subject to tax on worldwide taxable income. Taxable income is total gross income less certain exclusions, exemptions, and deductions. An individual may claim either a standard deduction or itemized deductions.

An individual's income tax liability is determined by computing his or her regular income tax liability and, if applicable, alternative minimum tax liability.

Regular income tax liability

Regular income tax liability is determined by applying the regular income tax rate schedules (or tax tables) to the individual's taxable income and then is reduced by any applicable tax credits. The regular income tax rate schedules are divided into several ranges of income, known as income brackets, and the marginal tax rate increases as the individual's income increases. The income bracket amounts are adjusted annually for inflation. Separate rate schedules apply based on filing status: single individuals (other than heads of households and surviving spouses), heads of households, married individuals filing joint returns (including surviving spouses), married individuals filing separate returns, and estates and trusts. Lower rates may apply to capital gains.

In general, the bracket breakpoints for single individuals are approximately 60 percent of the rate bracket breakpoints for married couples filing joint returns.[8] The rate bracket breakpoints for married individuals filing separate returns are exactly one-half of the rate brackets for married individuals filing joint returns. A separate, compressed rate schedule applies to estates and trusts.

REASONS FOR CHANGE

The Committee believes that the expansion of the 15-percent rate bracket for married couples filing joint returns, in conjunction with the other provisions of the bill, will alleviate the effects of the present-law marriage tax penalty. These provisions significantly reduce the most widely applicable marriage penalties in present law.

EXPLANATION OF PROVISION

The bill increases the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return to twice the size of the corresponding rate bracket for an unmarried individual filing a single return. The increase is phased-in over five years, beginning in 2006. Therefore, this provision is fully effective (i.e., the size of the 15-percent regular income tax rate bracket for a married couple filing a joint return would be twice the size of the 15-percent regular income tax rate bracket for an unmarried individual filing a single return) for taxable years beginning after December 31, 2009. Table 6, below, shows the increase in the size of the 15-percent bracket during the phase-in period.

TABLE 6.—INCREASE IN SIZE OF 15-PERCENT RATE BRACKET FOR MARRIED COUPLES FILING A JOINT RETURN

Taxable year	End point of 15-percent rate bracket for married couple filing joint return as percentage of end point of 15-percent rate bracket for unmarried individuals
2006	174
2007	180
2008	187
2009	193
2010 and thereafter	200%

[8] The rate bracket breakpoint for the 39.6 percent marginal tax rate is the same for single individuals and married couples filing joint returns.

EFFECTIVE DATE

The increase in the size of the 15-percent rate bracket is effective for taxable years beginning after December 31, 2005.

C. Marriage Penalty Relief and Simplification Relating to the Earned Income Credit

(Sec. 303 of the bill and Sec. 32 of the Code)

PRESENT LAW

In general

Eligible low-income workers are able to claim a refundable earned income credit. The amount of the credit an eligible taxpayer may claim depends upon the taxpayer's income and whether the taxpayer has one, more than one, or no qualifying children.

The earned income credit is not available to married individuals who file separate returns. No earned income credit is allowed if the taxpayer has disqualified income in excess of $2,450 (for 2001) for the taxable year.[9] In addition, no earned income credit is allowed if an eligible individual is the qualifying child of another taxpayer.[10]

Definition of qualifying child and tie-breaker rules

To claim the earned income credit, a taxpayer must either (1) have a qualifying child or (2) meet the requirements for childless adults. A qualifying child must meet a relationship test, an age test, and a residence test. First, the qualifying child must be the taxpayer's child, stepchild, adopted child, grandchild, or foster child. Second, the child must be under the age 19 (or under age 24 if a full-time student) or permanently and totally disabled regardless of age. Third, the child must live with the taxpayer in the United States for more than half the year (a full year for foster children).

An individual satisfies the relationship test under the earned income credit if the individual is the taxpayer's: (1) son or daughter or a descendant of either;[11] (2) stepson or stepdaughter; or (3) eligible foster child. An eligible foster child is an individual (1) who is a brother, sister, stepbrother, or stepsister of the taxpayer (or a descendant of any such relative), or who is placed with the taxpayer by an authorized placement agency, and (2) who the taxpayer cares for as her or his own child. A married child of the taxpayer is not treated as meeting the relationship test unless the taxpayer is entitled to a dependency exemption with respect to the married child (e.g., the support test is satisfied) or would be entitled to the exemption if the taxpayer had not waived the exemption to the noncustodial parent.[12]

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[9] Sec. 32(i). Disqualified income is the sum of: (1) interest and dividends includible in gross income for the taxable year; (2) tax-exempt income received or accrued in the taxable year; (3) net income from rents and royalties for the taxable year not derived in the ordinary course of business; (4) capital gain net income for the taxpayer year; and (5) net passive income for the taxable year. Sec. 32(i)(2).

[10] Sec. 32(c)(1)(B).

[11] A child who is legally adopted or placed with the taxpayer for adoption by an authorized adoption agency is treated as the taxpayer's own child. Sec. 32(c)(3)(B)(iv).

[12] Sec. 32(c)(3)(B)(ii).

If a child otherwise qualifies with respect to more than one person, the child is treated as a qualifying child only of the person with the highest modified adjusted gross income.

"Modified adjusted gross income" means adjusted gross income determined without regard to certain losses and increased by certain amounts not includible in gross income.[13] The losses disregarded are: (1) net capital losses (up to $3,000); (2) net losses from estates and trusts; (3) net losses from nonbusiness rents and royalties; (4) 75 percent of the net losses from businesses, computed separately with respect to sole proprietorships (other than farming), farming sole proprietorships, and other businesses. The amounts added to adjusted gross income to arrive at modified adjusted gross income include: (1) tax-exempt interest; and (2) nontaxable distributions from pensions, annuities, and individual retirement plans (but not nontaxable rollover distributions or trustee-to-trustee transfers).

Definition of earned income

To claim the earned income credit, the taxpayer must have earned income. Earned income consists of wages, salaries, other employee compensation, and net earnings from self employment.[14] Employee compensation includes anything of value received by the taxpayer from the employer in return for services of the employee, including nontaxable earned income. Nontaxable forms of compensation treated as earned income include the following: (1) elective deferrals under a cash or deferred arrangement or section 403(b) annuity (Sec. 402(g)); (2) employer contributions for nontaxable fringe benefits, including contributions for accident and health insurance (Sec. 106), dependent care (Sec. 129), adoption assistance (Sec. 137), educational assistance (Sec. 127), and miscellaneous fringe benefits (Sec. 132); (3) salary reduction contributions under a cafeteria plan (Sec. 125); (4) meals and lodging provided for the convenience of the employer (Sec. 119), and (5) housing allowance or rental value of a parsonage for the clergy (Sec. 107). Some of these items are not required to be reported on the Wage and Tax Statement (Form W–2).

Calculation of the credit

The maximum earned income credit is phased in as an individual's earned income increases. The credit phases out for individuals with earned income (or if greater, modified adjusted gross income) over certain levels. In the case of a married individual who files a joint return, the earned income credit both for the phase-in and phase-out is calculated based on the couples' combined income.

The credit is determined by multiplying the credit rate by the taxpayer's earned income up to a specified earned income amount. The maximum amount of the credit is the product of the credit rate and the earned income amount. The maximum credit amount applies to taxpayers with (1) earnings at or above the earned income amount and (2) modified adjusted gross income (or earnings, if greater) at or below the phase-out threshold level.

[13] Sec. 32(c)(5).
[14] Sec. 32(c)(2)(A).

For taxpayers with modified adjusted gross income (or earned income, if greater) in excess of the phase-out threshold, the credit amount is reduced by the phase-out rate multiplied by the amount of earned income (or modified adjusted gross income, if greater) in excess of the phase-out threshold. In other words, the credit amount is reduced, falling to $0 at the "breakeven" income level, the point where a specified percentage of "excess" income above the phase-out threshold offsets exactly the maximum amount of the credit. The earned income amount and the phase-out threshold are adjusted annually for inflation. Table 7, below, shows the earned income credit parameters for taxable year 2001.[15]

TABLE 7.—EARNED INCOME CREDIT PARAMETERS (2001)

	Two or more qualifying children	One qualifying child	No qualifying children
Credit rate (percent)	40.00%	34.00%	7.65%
Earned income amount	$10,020	$7,140	$4,760
Maximum credit	$4,008	$2,428	$364
Phase-out begins	$13,090	$13,090	$5,950
Phase-out rate (percent)	21.06%	15.98%	7.65%
Phase-out ends	$32,121	$28,281	$10,710

An individual's alternative minimum tax liability reduces the amount of the refundable earned income credit.[16]

REASONS FOR CHANGE

The Committee believes that the present-law earned income amount penalizes some individuals because they receive a smaller earned income credit if they are married than if they are not married. The Committee believes increasing the phase-out amount for married taxpayers who file a joint return will help to alleviate this penalty.

The bill repeals the present-law provision reducing the earned income credit by the amount of the alternative minimum tax. This provision ensures that no taxpayer will face an increase in net income tax liability as a result of the interaction of the alternative minimum tax with the regular income tax reductions in the bill.

The Committee believes that providing tax relief to Americans is a top priority. In addition, the Committee believes that simplification of our tax laws is important to alleviate the burdens on American taxpayers. As required by the IRS Restructuring and Reform Act of 1998, the staff of the Joint Committee on Taxation has recently released a simplification study.[17] The study contains approximately 150 recommendations for simplification reaching all areas of the Federal tax laws. As a first step toward simplification, the Committee believes it should consider simplification to the extent possible in the context of fulfilling the priority of providing needed tax relief. Thus, the Committee adopts three of the proposals recommended by the Joint Committee staff relating to the

[15] The table is based on Rev. Proc. 2001–13.
[16] Sec. 32(h).
[17] Joint Committee on Taxation, Study of the Overall State of the Federal Tax System and Recommendations for Simplification, Pursuant to Section 8022(3)(B) of the Internal Revenue Code of 1986 (JCS–3–01), April 2001.

earned income credit: (1) the definition of earned income, (2) replacement of the present-law tie-breaker rules, and (3) uniformity in the definition of a qualifying child.

The definition of earned income is a source of complexity insofar as it includes nontaxable forms of employee compensation. Present law requires both the IRS and taxpayers to keep track of nontaxable amounts for determining earned income credit eligibility even though such amounts are generally not necessary for other tax purposes. Further, not all forms of nontaxable earned income are reported on Form W–2. As a result, a taxpayer may not know the correct amount of nontaxable earned income received during the year. Further, the IRS cannot easily determine such amounts. The Committee believes that significant simplification would result from redefining earned income to exclude amounts not includable in gross income.

The present-law tie-breaker rules also result in significant complexity. When a qualifying child lives with more than one adult who appears to qualify to claim the child for earned income credit purposes, under present law, the adult with the highest modified adjusted gross income is to claim the child. In its most recent study, the IRS found that the second largest amount of errors, 17.1 percent of overclaims, was attributable to the person with the lower modified adjusted gross income claiming the child.[18] The Committee believes it is appropriate to replace the present-law tie-breaker rules with a more simplified rule that applies only in the case of competing claims.

The Committee applies the definition of qualifying child recommended by the staff of the Joint Committee for purposes of the earned income credit as a first step toward broader simplification efforts. The Committee believes that the distinctions among familial relationships drawn by present law in defining a qualifying child add to the complexity of the earned income credit. For example, a taxpayer's son or daughter is a qualifying child if he or she lived with the taxpayer for more than six months, while the taxpayer's niece or nephew is required to live with the taxpayer for the entire year, even though the taxpayer cared for the child as his or her own. In addition, foster children must reside with the taxpayer for the entire year as opposed to the general rule of six months. The Committee believes that applying a uniform rule that requires any qualifying child to reside with the taxpayer for more than six months will alleviate some of the complexity in this area.

The National Taxpayer Advocate has recommended the elimination of the use of modified adjusted gross income as a means to simplify the earned income credit.[19] The Committee believes that replacing modified adjusted gross income with adjusted gross income reduces the number of calculations required, thereby simplifying the credit.

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[18] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (September 2000), at 10.

[19] Internal Revenue Service, National Taxpayer Advocate's FY2000 Annual Report to Congress, Publication 2104 (December 2000) at 74.

The IRS recently reported that more than a quarter of earned income credit claims in 1997, $7.8 billion, were paid erroneously.[20] The IRS found that the most common error involved taxpayers claiming children who did not meet the eligibility criteria. The IRS attributes most of these errors to taxpayers claiming the earned income credit for children who do not meet the residency requirement.[21] Recently, the IRS began receiving data from the Department of Health and Human Services' Federal Case Registry of Child Support Orders, a Federal database containing state information on child support payments. This data assists the IRS in identifying erroneous earned income credit claims by noncustodial parents. The Committee believes that giving the IRS authority to deny questionable claims filed by noncustodial parents would reduce the erroneous filing and payment of earned income credit claims. The Committee, however, would like further information regarding the accuracy of the Federal Case Registry of Child Support Orders, its usefulness to the IRS in detecting erroneous or fraudulent claims, and the appropriateness of using math error procedures based on this data.

EXPLANATION OF PROVISION

For married taxpayers who file a joint return, the bill increases the beginning and ending of the earned income credit phase-out by $3,000. These beginning and ending points are to be adjusted annually for inflation after 2002.

The bill simplifies the definition of earned income by excluding nontaxable employee compensation from the definition of earned income for earned income credit purposes. Thus, under the bill, earned income includes wages, salaries, tips, and other employee compensation, if includible in gross income for the taxable year, plus net earnings from self employment.

The bill repeals the present-law provision that reduces the earned income credit by the amount of an individual's alternative minimum tax.

The bill simplifies the calculation of the earned income credit by replacing modified adjusted gross income with adjusted gross income.

The bill provides that the relationship test is met if the individual is the taxpayer's son, daughter, stepson, stepdaughter, or a descendant of any such individuals.[22] A brother, sister, stepbrother, stepsister, or a descendant of such individuals, also qualifies if the taxpayer cares for such individual as his or her own child. A foster child satisfies the relationship test as well. A foster child is defined as an individual who is placed with the taxpayer by an authorized placement agency and who the taxpayer cares for as his or her own child. In order to be a qualifying child, in all cases the child must have the same principal place of abode as the taxpayer for over one-half of the taxable year.

The bill changes the present-law tie-breaking rule. Under the bill, if an individual would be a qualifying child with respect to

[20] Internal Revenue Service, Compliance Estimates for Earned Income Tax Credit Claimed on 1997 Returns (September 2000), at 3.

[21] Id. at 10.

[22] As under present law, an adopted child is treated as a child of the taxpayer by blood.

more than one taxpayer, and more than one taxpayer claims the earned income credit with respect to that child, then the following tie-breaking rules apply. First, if one of the individuals claiming the child is the child's parent (or parents who file a joint return), then the child is considered the qualifying child of the parent (or parents). Second, if both parents claim the child and the parents do not file a joint return together, then the child is considered a qualifying child first of the parent with whom the child resided for the longest period of time during the year, and second of the parent with the highest adjusted gross income. Finally, if none of the taxpayers claiming the child as a qualifying child is the child's parent, the child is considered a qualifying child with respect to the taxpayer with the highest adjusted gross income.

The bill authorizes the IRS, beginning in 2004, to use math error authority to deny the earned income credit if the Federal Case Registry of Child Support Orders indicates that the taxpayer is the noncustodial parent of the child with respect to whom the credit is claimed.

It is the intent of the Committee that by September 2002, the Department of the Treasury, in consultation with the National Taxpayer Advocate, deliver to the Senate Committee on Finance and the House Committee on Ways and Means a study of the Federal Case Registry database. The study is to cover (1) the accuracy and timeliness of the data in the Federal Case Registry, (2) the efficacy of using math error authority in this instance in reducing costs due to erroneous or fraudulent claims, and (3) the implications of using math error authority in this instance, given the findings on the accuracy and timeliness of the data.

EFFECTIVE DATE

The bill generally is effective for taxable years beginning after December 31, 2001. The bill to authorize the IRS to use math error authority if the Federal Case Registry of Child Support Orders indicates the taxpayer is the noncustodial parent is effective beginning in 2004.

D. COMPLIANCE WITH CONGRESSIONAL BUDGET ACT

(Secs. 311 and 312 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to marriage penalty relief which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to marriage penalty relief which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

IV. EDUCATION INCENTIVES

A. Modifications to Education IRAs

(Sec. 401 of the bill and Sec. 530 of the Code)

PRESENT LAW

In general

Section 530 of the Code provides tax-exempt status to education individual retirement accounts ("education IRAs"), meaning certain trusts or custodial accounts which are created or organized in the United States exclusively for the purpose of paying the qualified higher education expenses of a designated beneficiary. Contributions to education IRAs may be made only in cash.[23] Annual contributions to education IRAs may not exceed $500 per beneficiary (except in cases involving certain tax-free rollovers, as described below) and may not be made after the designated beneficiary reaches age 18.

Phase-out of contribution limit

The $500 annual contribution limit for education IRAs is generally phased-out ratably for contributors with modified adjusted gross income (between $95,000 and $110,000. The phase-out range for married taxpayers filing a joint return is $150,000 to $160,000 of modified adjusted gross income. Individuals with modified adjusted gross income above the phase-out range are not allowed to make contributions to an education IRA established on behalf of any individual.

Treatment of distributions

Earnings on contributions to an education IRA generally are subject to tax when withdrawn. However, distributions from an education IRA are excludable from the gross income of the beneficiary to the extent that the total distribution does not exceed the "qualified higher education expenses" incurred by the beneficiary during the year the distribution is made.

If the qualified higher education expenses of the beneficiary for the year are less than the total amount of the distribution (i.e., contributions and earnings combined) from an education IRA, then the qualified higher education expenses are deemed to be paid from a pro-rata share of both the principal and earnings components of the distribution. Thus, in such a case, only a portion of the earnings are excludable (i.e., the portion of the earnings based on the ratio that the qualified higher education expenses bear to the total

[23] Special estate and gift tax rules apply to contributions made to and distributions made from education IRAs.

amount of the distribution) and the remaining portion of the earnings is includible in the beneficiary's gross income.

The earnings portion of a distribution from an education IRA that is includible in income is also subject to an additional 10-percent tax. The 10-percent additional tax does not apply if a distribution is made on account of the death or disability of the designated beneficiary, or on account of a scholarship received by the designated beneficiary.

The additional 10-percent tax also does not apply to the distribution of any contribution to an education IRA made during the taxable year if such distribution is made on or before the date that a return is required to be filed (including extensions of time) by the beneficiary for the taxable year during which the contribution was made (or, if the beneficiary is not required to file such a return, April 15th of the year following the taxable year during which the contribution was made).

Present law allows tax-free transfers or rollovers of account balances from one education IRA benefiting one beneficiary to another education IRA benefiting another beneficiary (as well as redesignations of the named beneficiary), provided that the new beneficiary is a member of the family of the old beneficiary and is under age 30.

Any balance remaining in an education IRA is deemed to be distributed within 30 days after the date that the beneficiary reaches age 30 (or, if earlier, within 30 days of the date that the beneficiary dies).

Qualified higher education expenses

The term "qualified higher education expenses" includes tuition, fees, books, supplies, and equipment required for the enrollment or attendance of the designated beneficiary at an eligible education institution, regardless of whether the beneficiary is enrolled at an eligible educational institution on a full-time, half-time, or less than half-time basis. Qualified higher education expenses include expenses with respect to undergraduate or graduate-level courses. In addition, qualified higher education expenses include amounts paid or incurred to purchase tuition credits (or to make contributions to an account) under a qualified State tuition program, as defined in section 529, for the benefit of the beneficiary of the education IRA.

Moreover, qualified higher education expenses include, within limits, room and board expenses for any academic period during which the beneficiary is at least a half-time student. Room and board expenses that may be treated as qualified higher education expenses are limited to the minimum room and board allowance applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment of the Small Business Job Protection Act of 1996 (August 20, 1996). Thus, room and board expenses cannot exceed the following amounts: (1) for a student living at home with parents or guardians, $1,500 per academic year; (2) for a student living in housing owned or operated by the eligible education institution, the institution's "normal" room and board charge; and (3) for all other students, $2,500 per academic year.

Qualified higher education expenses generally include only out-of-pocket expenses. Such qualified higher education expenses do not include expenses covered by educational assistance for the benefit of the beneficiary that is excludable from gross income. Thus, total qualified higher education expenses are reduced by scholarship or fellowship grants excludable from gross income under present-law section 117, as well as any other tax-free educational benefits, such as employer-provided educational assistance that is excludable from the employee's gross income under section 127.

Present law also provides that if any qualified higher education expenses are taken into account in determining the amount of the exclusion for a distribution from an education IRA, then no deduction (e.g., for trade or business expenses), exclusion (e.g., for interest on education savings bonds) or credit is allowed with respect to such expenses.

Eligible educational institutions are defined by reference to section 481 of the Higher Education Act of 1965. Such institutions generally are accredited post-secondary educational institutions offering credit toward a bachelor's degree, an associate's degree, a graduate-level or professional degree, or another recognized post-secondary credential. Certain proprietary institutions and post-secondary vocational institutions also are eligible institutions. The institution must be eligible to participate in Department of Education student aid programs.

Time for making contributions

Contributions to an education IRA for a taxable year are taken into account in the taxable year in which they are made.

Coordination with HOPE and Lifetime Learning credits

If an exclusion from gross income is allowed for distributions from an education IRA with respect to an individual, then neither the HOPE nor Lifetime Learning credit may be claimed in the same taxable year with respect to the same individual. However, an individual may elect to waive the exclusion with respect to distributions from an education IRA. If such a waiver is made, then the HOPE or Lifetime Learning credit may be claimed with respect to the individual for the taxable year.

Coordination with qualified tuition programs

An excise tax is imposed on contributions to an education IRA for a year if contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary in the same year. The excise tax is equal to 6 percent of the contributions to the education IRA. The excise tax is imposed each year after the contribution is made, unless the contributions are withdrawn.

REASONS FOR CHANGE

Education IRAs were intended to help families plan for their children's education. However, the Committee believes that the present-law limits on contributions to education IRAs do not permit taxpayers to save adequately. Therefore, the Committee bill increases the contribution limits to education IRAs.

The Committee believes that education IRAs should be expanded to provide greater flexibility to families in providing for their children's education at all levels of education. Thus, the Committee bill allows education IRAs to be used for expenses related to elementary and secondary education.

The Committee believes that other modifications will also improve the attractiveness and operation of education IRAs, thus improving the effectiveness of education IRAs in assisting families in paying for education. Such modifications include more flexible rules for education IRAs for special needs beneficiaries and relaxation of the rules restricting the use of education IRAs and other tax benefits for education in the same year.

EXPLANATION OF PROVISION

Annual contribution limit

The bill increases the annual limit on contributions to education IRAs from $500 to $2,000. Thus, aggregate contributions that may be made by all contributors to one (or more) education IRAs established on behalf of any particular beneficiary is limited to $2,000 for each year.

Qualified education expenses

The bill expands the definition of qualified education expenses that may be paid tax-free from an education IRA to include "qualified elementary and secondary school expenses," meaning expenses for (1) tuition, fees, academic tutoring, special need services, books, supplies, computer equipment (including related software and services), and other equipment incurred in connection with the enrollment or attendance of the beneficiary at a public, private, or religious school providing elementary or secondary education (kindergarten through grade 12) as determined under State law, and (2) room and board, uniforms, transportation, and supplementary items or services (including extended day programs) required or provided by such a school in connection with such enrollment or attendance of the beneficiary.

Phase-out of contribution limit

The bill increases the phase-out range for married taxpayers filing a joint return so that it is twice the range for single taxpayers. Thus, the phase-out range for married taxpayers filing a joint return is $190,000 to $220,000 of modified adjusted gross income.

Special needs beneficiaries

The bill provides that the rule prohibiting contributions to an education IRA after the beneficiary attains 18 does not apply in the case of a special needs beneficiary (as defined by Treasury Department regulations). In addition, a deemed distribution of any balance in an education IRA does not occur when a special needs beneficiary reaches age 30.

Contributions by persons other than individuals

The bill clarifies that corporations and other entities (including tax-exempt organizations) are permitted to make contributions to education IRAs, regardless of the income of the corporation or entity during the year of the contribution.

Contributions permitted until April 15

Under the bill, individual contributors to education IRAs are deemed to have made a contribution on the last day of the preceding taxable year if the contribution is made on account of such taxable year and is made not later than the time prescribed by law for filing the individual's Federal income tax return for such taxable year (not including extensions). Thus, individual contributors generally may make contributions for a year until April 15 of the following year.

Qualified room and board expenses

The bill modifies the definition of room and board expenses considered to be qualified higher education expenses. This modification is described with the provisions relating to qualified tuition programs, below.

Coordination with HOPE and Lifetime Learning credits

The bill allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the contributions and the earnings portions) from an education IRA on behalf of the same student as long as the distribution is not used for the same educational expenses for which a credit was claimed.

Coordination with qualified tuition programs

The bill repeals the excise tax on contributions made by any person to an education IRA on behalf of a beneficiary during any taxable year in which any contributions are made by anyone to a qualified State tuition program on behalf of the same beneficiary.

If distributions from education IRAs and qualified tuition programs exceed the beneficiary's qualified higher education expenses for the year (after reduction by amounts used in claiming the HOPE or Lifetime Learning credit), the beneficiary is required to allocate the expenses between the distributions to determine the amount includible in income.

EFFECTIVE DATE

The provisions modifying education IRAs are effective for taxable years beginning after December 31, 2001.

B. Private Prepaid Tuition Programs; Exclusion From Gross Income of Education Distributions From Qualified Tuition Programs

(Sec. 402 of the bill and Sec. 529 of the Code)

PRESENT LAW

Section 529 of the Code provides tax-exempt status to "qualified State tuition programs," meaning certain programs established and maintained by a State (or agency or instrumentality thereof) under which persons may (1) purchase tuition credits or certificates on behalf of a designated beneficiary that entitle the beneficiary to a waiver or payment of qualified higher education expenses of the beneficiary, or (2) make contributions to an account that is established for the purpose of meeting qualified higher education expenses of the designated beneficiary of the account (a "savings account plan"). The term "qualified higher education expenses" generally has the same meaning as does the term for purposes of education IRAs (as described above) and, thus, includes expenses for tuition, fees, books, supplies, and equipment required for the enrollment or attendance at an eligible educational institution,[24] as well as certain room and board expenses for any period during which the student is at least a half-time student.

No amount is included in the gross income of a contributor to, or a beneficiary of, a qualified State tuition program with respect to any distribution from, or earnings under, such program, except that (1) amounts distributed or educational benefits provided to a beneficiary are included in the beneficiary's gross income (unless excludable under another Code section) to the extent such amounts or the value of the educational benefits exceed contributions made on behalf of the beneficiary, and (2) amounts distributed to a contributor (e.g., when a parent receives a refund) are included in the contributor's gross income to the extent such amounts exceed contributions made on behalf of the beneficiary.[25]

A qualified State tuition program is required to provide that purchases or contributions only be made in cash.[26] Contributors and beneficiaries are not allowed to direct the investment of contributions to the program (or earnings thereon). The program is required to maintain a separate accounting for each designated beneficiary. A specified individual must be designated as the beneficiary at the commencement of participation in a qualified State tuition program (i.e., when contributions are first made to purchase an interest in such a program), unless interests in such a program are purchased by a State or local government or a tax-exempt charity described in section 501(c)(3) as part of a scholarship program operated by such government or charity under which beneficiaries to be named in the future will receive such interests as scholarships.

A transfer of credits (or other amounts) from one account benefiting one designated beneficiary to another account benefiting a different beneficiary is considered a distribution (as is a change in the designated beneficiary of an interest in a qualified State tuition program), unless the beneficiaries are members of the same family. For this purpose, the term "member of the family" means: (1) the spouse of the beneficiary; (2) a son or daughter of the beneficiary or a descendent of either; (3) a stepson or stepdaughter of the beneficiary; (4) a brother, sister, stepbrother or stepsister of the beneficiary; (5) the father or mother of the beneficiary or an ancestor of either; (6) a stepfather or stepmother of the beneficiary; (7) a son or daughter of a brother or sister of the beneficiary; (8) a brother or sister of the father or mother of the beneficiary; (9) a son-in-law,

[24] An "eligible education institution" is defined the same for purposes of education IRAs (described above) and qualified State tuition programs.

[25] Distributions from qualified State tuition programs are treated as representing a pro-rata share of the contributions and earnings in the account.

[26] Special estate and gift tax rules apply to contributions made to and distributions made from qualified State tuition programs.

daughter-in-law, father-in-law, mother-in-law, brother-in-law, or sister-in-law of the beneficiary; or (10) the spouse of any person described in (2)–(9).

Earnings on an account may be refunded to a contributor or beneficiary, but the State or instrumentality must impose a more than de minimis monetary penalty unless the refund is (1) used for qualified higher education expenses of the beneficiary, (2) made on account of the death or disability of the beneficiary, (3) made on account of a scholarship received by the beneficiary, or (4) a rollover distribution.

To the extent that a distribution from a qualified State tuition program is used to pay for qualified tuition and related expenses (as defined in sec. 25A(f)(1)), the beneficiary (or another taxpayer claiming the beneficiary as a dependent) may claim the HOPE credit or Lifetime Learning credit with respect to such tuition and related expenses (assuming that the other requirements for claiming the HOPE credit or Lifetime Learning credit are satisfied and the modified AGI phase-out for those credits does not apply).

REASONS FOR CHANGE

The Committee believes that distributions from qualified State tuition programs should not be subject to Federal income tax to the extent that such distributions are used to pay for qualified higher education expenses of undergraduate or graduate students who are attending college, university, or certain vocational schools. In addition, the Committee believes that the present-law rules governing qualified tuition programs should be expanded to permit private educational institutions to maintain certain prepaid tuition programs. The Committee believes that the amount of room and board expenses that can be paid with tax-free distributions from prepaid tuition plans should reflect current costs.

EXPLANATION OF PROVISION

Qualified tuition program

The bill expands the definition of "qualified tuition program" to include certain prepaid tuition programs established and maintained by one or more eligible educational institutions (which may be private institutions) that satisfy the requirements under section 529 (other than the present-law State sponsorship rule). In the case of a qualified tuition program maintained by one or more private eligible educational institutions, persons are able to purchase tuition credits or certificates on behalf of a designated beneficiary (as set forth in sec. 529(b)(1)(A)(i)), but would not be able to make contributions to a savings account plan (as described in sec. 529(b)(1)(A)(ii)). Except to the extent provided in regulations, a tuition program maintained by a private institution is not treated as qualified unless it has received a ruling or determination from the IRS that the program satisfies applicable requirements.

Exclusion from gross income

Under the bill, an exclusion from gross income is provided for distributions made in taxable years beginning after December 31, 2001, from qualified State tuition programs to the extent that the distribution is used to pay for qualified higher education expenses. This exclusion from gross income is extended to distributions from qualified tuition programs established and maintained by an entity other than a State (or agency or instrumentality thereof) for distributions made in taxable years after December 31, 2003.

Qualified higher education expenses

The bill provides that, for purposes of the exclusion for distributions from qualified tuition plans, the maximum room and board allowance is the amount applicable to the student in calculating costs of attendance for Federal financial aid programs under section 472 of the Higher Education Act of 1965, as in effect on the date of enactment, or, in the case of a student living in housing owned or operated by an eligible educational institution, the actual amount charged the student by the educational institution for room and board.[27]

Coordination with HOPE and Lifetime Learning credits

The bill allows a taxpayer to claim a HOPE credit or Lifetime Learning credit for a taxable year and to exclude from gross income amounts distributed (both the principal and the earnings portions) from a qualified tuition program on behalf of the same student as long as the distribution is not used for the same expenses for which a credit was claimed.

Rollovers for benefit of same beneficiary

The bill provides that a transfer of credits (or other amounts) from one qualified tuition program for the benefit of a designated beneficiary to another qualified tuition program for the benefit of the same beneficiary is not considered a distribution. This rollover treatment applies to a maximum of three such transfers with respect to the same designated beneficiary.

Member of family

The bill provides that, for purposes of tax-free rollovers and changes of designated beneficiaries, a "member of the family" includes first cousins of the original beneficiary.

EFFECTIVE DATE

The provisions are effective for taxable years beginning after December 31, 2001, except that the exclusion from gross income for certain distributions from a qualified tuition program established and maintained by an entity other than a State (or agency or instrumentality thereof) is effective for taxable years beginning after December 31, 2003.

[27] This definition also applies to distributions from education IRAs.

C. Exclusion for Employer-Provided Educational Assistance

(Sec. 411 of the bill and Sec. 127 of the Code)

PRESENT LAW

Educational expenses paid by an employer for its employees are generally deductible by the employer.

Employer-paid educational expenses are excludable from the gross income and wages of an employee if provided under a section 127 educational assistance plan or if the expenses qualify as a working condition fringe benefit under section 132. Section 127 provides an exclusion of $5,250 annually for employer-provided educational assistance. The exclusion does not apply to graduate courses beginning after June 30, 1996. The exclusion for employer-provided educational assistance for undergraduate courses expires with respect to courses beginning after December 31, 2001.

In order for the exclusion to apply, certain requirements must be satisfied. The educational assistance must be provided pursuant to a separate written plan of the employer. The educational assistance program must not discriminate in favor of highly compensated employees. In addition, not more than five percent of the amounts paid or incurred by the employer during the year for educational assistance under a qualified educational assistance plan can be provided for the class of individuals consisting of more than five percent owners of the employer (and their spouses and dependents).

Educational expenses that do not qualify for the section 127 exclusion may be excludable from income as a working condition fringe benefit.[28] In general, education qualifies as a working condition fringe benefit if the employee could have deducted the education expenses under section 162 if the employee paid for the education. In general, education expenses are deductible by an individual under section 162 if the education (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, applicable law or regulations imposed as a condition of continued employment. However, education expenses are generally not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business.[29]

REASONS FOR CHANGE

The Committee believes that the exclusion for employer-provided educational assistance has enabled millions of workers to advance their education and improve their job skills without incurring additional taxes and a reduction in take-home pay. In addition, the exclusion lessens the complexity of the tax laws. Without the special exclusion, a worker receiving educational assistance from his or her

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[28] These rules also apply in the event that section 127 expires.

[29] In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses, along with other miscellaneous expenses, exceed two percent of the taxpayer's AGI. An individual's total deductions may also be reduced by the overall limitation on itemized deductions under section 68. These limitations do not apply in determining whether an item is excludable from income as a working condition fringe benefit.

employer is subject to tax on the assistance, unless the education is related to the worker's current job. Because the determination of whether particular educational assistance is job related is based on the facts and circumstances, it may be difficult to determine with certainty whether the educational assistance is excludable from income. This uncertainty may lead to disputes between taxpayers and the Internal Revenue Service.

The Committee believes that reinstating the exclusion for graduate-level employer-provided educational assistance will enable more individuals to seek higher education, and that further extension of the exclusion is important.

The past experience of allowing the exclusion to expire and later extending it retroactively has created burdens for employers and employees. Employees may have difficulty planning for their educational goals if they do not know whether their tax bills will increase. For employers, the lack of permanence of the provision has caused severe administrative problems. Uncertainty about the exclusion's future may discourage some employers from providing educational benefits.

EXPLANATION OF PROVISION

The provision extends the exclusion for employer-provided educational assistance to graduate education and makes the exclusion (as applied to both undergraduate and graduate education) permanent.

EFFECTIVE DATE

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

D. Modifications to Student Loan Interest Deduction

(Sec. 412 of the bill and Sec. 221 of the Code)

PRESENT LAW

Certain individuals may claim an above-the-line deduction for interest paid on qualified education loans, subject to a maximum annual deduction limit. The deduction is allowed only with respect to interest paid on a qualified education loan during the first 60 months in which interest payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60-month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

The maximum allowable annual deduction is $2,500. The deduction is phased-out ratably for single taxpayers with modified adjusted gross income between $40,000 and $55,000 and for married taxpayers filing joint returns with modified adjusted gross income between $60,000 and $75,000. The income ranges will be adjusted for inflation after 2002.

REASONS FOR CHANGE

The Committee believes that it is appropriate to expand the deduction for individuals who pay interest on qualified education loans by repealing the limitation that the deduction is allowed only with respect to interest paid during the first 60 months in which interest payments are required. In addition, the repeal of the 60-month limitation lessens complexity and administrative burdens for taxpayers, lenders, loan servicing agencies, and the Internal Revenue Service. The Committee also believes it appropriate to increase the income phase-out ranges applicable to the student loan interest deduction to make the deduction available to more taxpayers and to reduce the potential marriage penalty caused by the phase-out ranges.

EXPLANATION OF PROVISION

The bill increases the income phase-out ranges for eligibility for the student loan interest deduction to $50,000 to $65,000 for single taxpayers and to $100,000 to $130,000 for married taxpayers filing joint returns. These income phase-out ranges are adjusted annually for inflation after 2002.

The bill repeals both the limit on the number of months during which interest paid on a qualified education loan is deductible and the restriction that voluntary payments of interest are not deductible.

EFFECTIVE DATE

The provision is effective for interest paid on qualified education loans after December 31, 2001.

E. Eliminate Tax on Awards Under the National Health Service Corps Scholarship Program and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program

(Sec. 413 of the bill and Sec. 117 of the Code)

PRESENT LAW

Section 117 excludes from gross income amounts received as a qualified scholarship by an individual who is a candidate for a degree and used for tuition and fees required for the enrollment or attendance (or for fees, books, supplies, and equipment required for courses of instruction) at a primary, secondary, or post-secondary educational institution. The tax-free treatment provided by section

117 does not extend to scholarship amounts covering regular living expenses, such as room and board. In addition to the exclusion for qualified scholarships, section 117 provides an exclusion from gross income for qualified tuition reductions for certain education provided to employees (and their spouses and dependents) of certain educational organizations.

The exclusion for qualified scholarships and qualified tuition reductions does not apply to any amount received by a student that represents payment for teaching, research, or other services by the student required as a condition for receiving the scholarship or tuition reduction.

The National Health Service Corps Scholarship Program (the "NHSC Scholarship Program") and the F. Edward Hebert Armed Forces Health Professions Scholarship and Financial Assistance Program (the "Armed Forces Scholarship Program") provide education awards to participants on the condition that the participants provide certain services. In the case of the NHSC Program, the recipient of the scholarship is obligated to provide medical services in a geographic area (or to an underserved population group or designated facility) identified by the Public Health Service as having a shortage of health care professionals. In the case of the Armed Forces Scholarship Program, the recipient of the scholarship is obligated to serve a certain number of years in the military at an armed forces medical facility. Because the recipients are required to perform services in exchange for the education awards, the awards used to pay higher education expenses are taxable income to the recipient.

REASONS FOR CHANGE

The Committee believes it appropriate to provide tax-free treatment for scholarships received by medical, dental, nursing, and physician assistant students under the NHSC Scholarship Program and the Armed Forces Scholarship Program.

EXPLANATION OF PROVISION

The bill provides that amounts received by an individual under the NHSC Scholarship Program or the Armed Forces Scholarship Program are eligible for tax-free treatment as qualified scholarships under section 117, without regard to any service obligation by the recipient. As with other qualified scholarships under section 117, the tax-free treatment does not apply to amounts received by students for regular living expenses, including room and board.

EFFECTIVE DATE

The provision is effective for education awards received after December 31, 2001.

F. Tax Benefits for Certain Types of Bonds for Educational Facilities and Activities

(Secs. 421–422 of the bill and Secs. 142 and 146–148 of the Code)

PRESENT LAW

Tax-exempt bonds

In general

Interest on debt[30] incurred by States or local governments is excluded from income if the proceeds of the borrowing are used to carry out governmental functions of those entities or the debt is repaid with governmental funds (Sec. 103).[31] Like other activities carried out or paid for by States and local governments, the construction, renovation, and operation of public schools is an activity eligible for financing with the proceeds of tax-exempt bonds.

Interest on bonds that nominally are issued by States or local governments, but the proceeds of which are used (directly or indirectly) by a private person and payment of which is derived from funds of such a private person is taxable unless the purpose of the borrowing is approved specifically in the Code or in a non-Code provision of a revenue Act. These bonds are called "private activity bonds."[32] The term "private person" includes the Federal Government and all other individuals and entities other than States or local governments.

Private activities eligible for financing with tax-exempt private activity bonds

Present law includes several exceptions permitting States or local governments to act as conduits providing tax-exempt financing for private activities. Both capital expenditures and limited working capital expenditures of charitable organizations described in section 501(c)(3) of the Code—including elementary, secondary, and post-secondary schools—may be financed with tax-exempt private activity bonds ("qualified 501(c)(3) bonds").

States or local governments may issue tax-exempt "exempt-facility bonds" to finance property for certain private businesses. Business facilities eligible for this financing include transportation (airports, ports, local mass commuting, and high speed intercity rail facilities); privately owned and/or privately operated public works facilities (sewage, solid waste disposal, local district heating or cooling, and hazardous waste disposal facilities); privately-owned and/or operated low-income rental housing; and certain private facilities for the local furnishing of electricity or gas. A further provision allows tax-exempt financing for "environmental enhancements of hydro-electric generating facilities." Tax-exempt financing also is authorized for capital expenditures for small manufacturing facilities and land and equipment for first-time farmers ("qualified small-issue bonds"), local redevelopment activities ("qualified rede-

[30] Hereinafter referred to as "State or local government bonds."
[31] Interest on this debt is included in calculating the "adjusted current earnings" preference of the corporate alternative minimum tax.
[32] Interest on private activity bonds (other than qualified 501(c)(3) bonds) is a preference item in calculating the alternative minimum tax.

velopment bonds"), and eligible empowerment zone and enterprise community businesses. Tax-exempt private activity bonds also may be issued to finance limited non-business purposes: certain student loans and mortgage loans for owner-occupied housing ("qualified mortgage bonds" and "qualified veterans' mortgage bonds").

Private activity tax-exempt bonds may not be issued to finance schools for private, for-profit businesses.

In most cases, the aggregate volume of private activity tax-exempt bonds is restricted by annual aggregate volume limits imposed on bonds issued by issuers within each State. These annual volume limits are equal to $62.50 per resident of the State, or $187.5 million if greater. The volume limits are scheduled to increase to the greater of $75 per resident of the State or $225 million in calendar year 2002. After 2002, the volume limits will be indexed annually for inflation.

Arbitrage restrictions on tax-exempt bonds

The Federal income tax does not apply to the income of States and local governments that is derived from the exercise of an essential governmental function. To prevent these tax-exempt entities from issuing more Federally subsidized tax-exempt bonds than is necessary for the activity being financed or from issuing such bonds earlier than needed for the purpose of the borrowing, the Code includes arbitrage restrictions limiting the ability to profit from investment of tax-exempt bond proceeds. In general, arbitrage profits may be earned only during specified periods (e.g., defined "temporary periods" before funds are needed for the purpose of the borrowing) or on specified types of investments (e.g., "reasonably required reserve or replacement funds"). Subject to limited exceptions, profits that are earned during these periods or on such investments must be rebated to the Federal Government.

Present law includes three exceptions to the arbitrage rebate requirements applicable to education-related bonds. First, issuers of all types of tax-exempt bonds are not required to rebate arbitrage profits if all of the proceeds of the bonds are spent for the purpose of the borrowing within six months after issuance.[33]

Second, in the case of bonds to finance certain construction activities, including school construction and renovation, the six-month period is extended to 24 months. Arbitrage profits earned on construction proceeds are not required to be rebated if all such proceeds (other than certain retainage amounts) are spent by the end of the 24-month period and prescribed intermediate spending percentages are satisfied.[34] Issuers qualifying for this "construction bond" exception may elect to be subject to a fixed penalty payment regime in lieu of rebate if they fail to satisfy the spending requirements.

Third, governmental bonds issued by "small" governments are not subject to the rebate requirement. Small governments are defined as general purpose governmental units that issue no more

[33] In the case of governmental bonds (including bonds to finance public schools), the six-month expenditure exception is treated as satisfied if at least 95 percent of the proceeds is spent within six months and the remaining five percent is spent within 12 months after the bonds are issued.

[34] Retainage amounts are limited to no more than five percent of the bond proceeds, and these amounts must be spent for the purpose of the borrowing no later than 36 months after the bonds are issued.

than $5 million of tax-exempt governmental bonds in a calendar year. The $5 million limit is increased to $10 million if at least $5 million of the bonds are used to finance public schools.[35]

Qualified zone academy bonds

As an alternative to traditional tax-exempt bonds, States and local governments are given the authority to issue "qualified zone academy bonds." Under present law, a total of $400 million of qualified zone academy bonds may be issued in each of 1998 through 2001. The $400 million aggregate bond authority is allocated each year to the States according to their respective populations of individuals below the poverty line. Each State, in turn, allocates the credit to qualified zone academies within such State. A State may carry over any unused allocation for up to two years (three years for authority arising before 2000).

Certain financial institutions (i.e., banks, insurance companies, and corporations actively engaged in the business of lending money) that hold qualified zone academy bonds are entitled to a nonrefundable tax credit in an amount equal to a credit rate multiplied by the face amount of the bond. An eligible financial institution holding a qualified zone academy bond on the credit allowance date (i.e., each one-year anniversary of the issuance of the bond) is entitled to a credit. The credit amount is includible in gross income (as if it were a taxable interest payment on the bond), and the credit may be claimed against regular income tax and alternative minimum tax liability.

The Treasury Department sets the credit rate daily at a rate estimated to allow issuance of qualified zone academy bonds without discount and without interest cost to the issuer. The maximum term of the bonds also is determined by the Treasury Department, so that the present value of the obligation to repay the bond is 50 percent of the face value of the bond. Present value is determined using as a discount rate the average annual interest rate of tax-exempt obligations with a term of 10 years or more issued during the month.

"Qualified zone academy bonds" are defined as bonds issued by a State or local government, provided that: (1) at least 95 percent of the proceeds is used for the purpose of renovating, providing equipment to, developing course materials for use at, or training teachers and other school personnel in a "qualified zone academy" and (2) private entities have promised to contribute to the qualified zone academy certain equipment, technical assistance or training, employee services, or other property or services with a value equal to at least 10 percent of the bond proceeds.

A school is a "qualified zone academy" if (1) the school is a public school that provides education and training below the college level, (2) the school operates a special academic program in cooperation with businesses to enhance the academic curriculum and increase graduation and employment rates, and (3) either (a) the school is located in a designated empowerment zone or a designated enter-

[35] The Small Business Job Protection Act of 1996 permitted issuance of the additional $5 million in public school bonds by small governments. Previously, small governments were defined as governments that issued no more than $5 million of governmental bonds without regard to the purpose of the financing.

prise community, or (b) it is reasonably expected that at least 35 percent of the students at the school will be eligible for free or reduced-cost lunches under the school lunch program established under the National School Lunch Act.

REASONS FOR CHANGE

The policy underlying the arbitrage rebate exception for bonds of small governmental units is to reduce complexity for these entities because they may not have in-house financial staff to engage in the expenditure and investment tracking necessary for rebate compliance. The exception further is justified by the limited potential for arbitrage profits at small issuance levels and limitation of the provision to governmental bonds, which typically require voter approval before issuance. The Committee believes that a limited increase of $5 million per year for public school construction bonds will more accurately conform this present-law exception to current school construction costs.

Further, the Committee wishes to encourage public-private partnerships to improve educational opportunities. To permit public-private partnerships to reap the benefit of the implicit subsidy to capital costs provided through tax-exempt financing, the Committee determined that it is appropriate to allow the issuance of tax-exempt private activity bonds for public school facilities.

EXPLANATION OF PROVISIONS

Increase amount of governmental bonds that may be issued by governments qualifying for the "small governmental unit" arbitrage rebate exception

The additional amount of governmental bonds for public schools that small governmental units may issue without being subject to the arbitrage rebate requirements is increased from $5 million to $10 million. Thus, these governmental units may issue up to $15 million of governmental bonds in a calendar year provided that at least $10 million of the bonds are used to finance public school construction expenditures.

Allow issuance of tax-exempt private activity bonds for public school facilities

The private activities for which tax-exempt bonds may be issued are expanded to include elementary and secondary public school facilities which are owned by private, for-profit corporations pursuant to public-private partnership agreements with a State or local educational agency. The term school facility includes school buildings and functionally related and subordinate land (including stadiums or other athletic facilities primarily used for school events)[36] and depreciable personal property used in the school facility. The school facilities for which these bonds are issued must be operated by a public educational agency as part of a system of public schools.

A public-private partnership agreement is defined as an arrangement pursuant to which the for-profit corporate party constructs, rehabilitates, refurbishes or equips a school facility for a public

[36] The present-law limit on the amount of the proceeds of a private activity bond issue that may be used to finance land acquisition does not apply to these bonds.

school agency (typically pursuant to a lease arrangement). The agreement must provide that, at the end of the contract term, ownership of the bond-financed property is transferred to the public school agency party to the agreement for no additional consideration.

Issuance of these bonds is subject to a separate annual per-State private activity bond volume limit equal to $10 per resident ($5 million, if greater) in lieu of the present-law State private activity bond volume limits. As with the present-law State private activity bond volume limits, States can decide how to allocate the bond authority to State and local government agencies. Bond authority that is unused in the year in which it arises may be carried forward for up to three years for public school projects under rules similar to the carryforward rules of the present-law private activity bond volume limits.

EFFECTIVE DATE

The provisions are effective for bonds issued after December 31, 2001.

G. DEDUCTION FOR QUALIFIED HIGHER EDUCATION EXPENSES

(Sec. 431 of the bill and new Sec. 222 of the Code)

PRESENT LAW

Deduction for education expenses

Under present law, an individual taxpayer generally may not deduct the education and training expenses of the taxpayer or the taxpayer's dependents. However, a deduction for education expenses generally is allowed under Internal Revenue Code ("the Code") section 162 if the education or training (1) maintains or improves a skill required in a trade or business currently engaged in by the taxpayer, or (2) meets the express requirements of the taxpayer's employer, or requirements of applicable law or regulations, imposed as a condition of continued employment (Treas. Reg. sec. 1.162–5). Education expenses are not deductible if they relate to certain minimum educational requirements or to education or training that enables a taxpayer to begin working in a new trade or business. In the case of an employee, education expenses (if not reimbursed by the employer) may be claimed as an itemized deduction only if such expenses meet the above described criteria for deductibility under section 162 and only to the extent that the expenses, along with other miscellaneous deductions, exceed 2 percent of the taxpayer's adjusted gross income.

HOPE and Lifetime Learning credits

HOPE credit

Under present law, individual taxpayers are allowed to claim a nonrefundable credit, the "HOPE" credit, against Federal income taxes of up to $1,500 per student per year for qualified tuition and related expenses paid for the first two years of the student's post secondary education in a degree or certificate program. The HOPE credit rate is 100 percent on the first $1,000 of qualified tuition and related expenses, and 50 percent on the next $1,000 of qualified tuition and related expenses.[37] The qualified tuition and related expenses must be incurred on behalf of the taxpayer, the taxpayer's spouse, or a dependent of the taxpayer. The HOPE credit is available with respect to an individual student for two taxable years, provided that the student has not completed the first two years of post-secondary education before the beginning of the second taxable year.[38] The HOPE credit that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns). For taxable years beginning after 2001, the $1,500 maximum HOPE credit amount and the AGI phase-out ranges are indexed for inflation.

The HOPE credit is available for "qualified tuition and related expenses," which include tuition and fees required to be paid to an eligible educational institution as a condition of enrollment or attendance of an eligible student at the institution. Charges and fees associated with meals, lodging, insurance, transportation, and similar personal, living, or family expenses are not eligible for the credit. The expenses of education involving sports, games, or hobbies are not qualified tuition and related expenses unless this education is part of the student's degree program.

Qualified tuition and related expenses generally include only out-of-pocket expenses. Qualified tuition and related expenses do not include expenses covered by employer-provided educational assistance and scholarships that are not required to be included in the gross income of either the student or the taxpayer claiming the credit. Thus, total qualified tuition and related expenses are reduced by any scholarship or fellowship grants excludable from gross income under section 117 and any other tax free educational benefits received by the student (or the taxpayer claiming the credit) during the taxable year.

Lifetime Learning credit

Individual taxpayers are allowed to claim a nonrefundable credit, the Lifetime Learning credit, against Federal income taxes equal to 20 percent of qualified tuition and related expenses incurred during the taxable year on behalf of the taxpayer, the taxpayer's spouse, or any dependents. For expenses paid after June 30, 1998, and prior to January 1, 2003, up to $5,000 of qualified tuition and related expenses per taxpayer return are eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return is $1,000). For expenses paid after December 31, 2002, up to $10,000 of qualified tuition and related expenses per taxpayer return will be eligible for the Lifetime Learning credit (i.e., the maximum credit per taxpayer return will be $2,000).

In contrast to the HOPE credit, a taxpayer may claim the Lifetime Learning credit for an unlimited number of taxable years. Also in contrast to the HOPE credit, the maximum amount of the

[37] Thus, an eligible student who incurs $1,000 of qualified tuition and related expenses is eligible (subject to the AGI phase-out) for a $1,000 HOPE credit. If an eligible student incurs $2,000 of qualified tuition and related expenses, then he or she is eligible for a $1,500 HOPE credit.

[38] The HOPE credit may not be claimed against a taxpayer's alternative minimum tax liability.

Lifetime Learning credit that may be claimed on a taxpayer's return will not vary based on the number of students in the taxpayer's family—that is, the HOPE credit is computed on a per student basis, while the Lifetime Learning credit is computed on a family wide basis. The Lifetime Learning credit amount that a taxpayer may otherwise claim is phased-out ratably for taxpayers with modified AGI between $40,000 and $50,000 ($80,000 and $100,000 for joint returns).

REASONS FOR CHANGE

The Committee recognizes that in some cases a deduction for education expenses may provide greater tax relief than the present-law credits. The Committee wishes to maximize tax benefits for education, and provide greater choice for taxpayers in determining which tax benefit is most appropriate for them.

EXPLANATION OF PROVISION

The bill permits taxpayers an above-the-line deduction for qualified higher education expenses paid by the taxpayer during a taxable year. Qualified higher education expenses are defined in the same manner as for purposes of the HOPE credit.

In 2002 and 2003, taxpayers with adjusted gross income[39] that does not exceed $65,000 ($130,000 in the case of married couples filing joint returns) are entitled to a maximum deduction of $3,000 per year. Taxpayers with adjusted gross income above these thresholds would not be entitled to a deduction. In 2004 and 2005, taxpayers with adjusted gross income that does not exceed $65,000 ($130,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $5,000 and taxpayers with adjusted gross income that does not exceed $80,000 ($160,000 in the case of married taxpayers filing joint returns) are entitled to a maximum deduction of $2,000.

Taxpayers are not eligible to claim the deduction and a HOPE or Lifetime Learning Credit in the same year with respect to the same student. A taxpayer may claim an exclusion for distributions from a qualified tuition plan, distributions from an education individual retirement account, or interest on education savings bonds, as long as both a deduction and an exclusion are not claimed for the same expenses.

EFFECTIVE DATE

The provision is effective for payments made in taxable years beginning after December 31, 2001, and before January 1, 2006.

H. Credit for Interest on Qualified Higher Education Loans

(Sec. 432 of the bill and new Sec. 25B of the Code)

PRESENT LAW

An above-the-line deduction for interest paid on qualified education loans is permitted during the first 60 months in which inter-

[39] The provision contains ordering rules for use in determining adjusted gross income for purposes of the deduction.

est payments are required. Required payments of interest generally do not include voluntary payments, such as interest payments made during a period of loan forbearance. Months during which interest payments are not required because the qualified education loan is in deferral or forbearance do not count against the 60–month period. No deduction is allowed to an individual if that individual is claimed as a dependent on another taxpayer's return for the taxable year.

The maximum allowable annual deduction is $2,500. The deduction is phased-out ratably for single taxpayers with modified adjusted gross income between $40,000 and $55,000 and for married taxpayers filing joint returns with modified adjusted gross income between $60,000 and $75,000. The income ranges will be adjusted for inflation after 2002.[40]

A qualified education loan generally is defined as any indebtedness incurred solely to pay for certain costs of attendance (including room and board) of a student (who may be the taxpayer, the taxpayer's spouse, or any dependent of the taxpayer as of the time the indebtedness was incurred) who is enrolled in a degree program on at least a half-time basis at (1) an accredited post-secondary educational institution defined by reference to section 481 of the Higher Education Act of 1965, or (2) an institution conducting an internship or residency program leading to a degree or certificate from an institution of higher education, a hospital, or a health care facility conducting postgraduate training.

REASONS FOR CHANGE

The Committee wishes to make the payment of higher education less costly for taxpayers and to give taxpayers a choice in maximizing their tax benefits. A credit for interest paid on qualified higher education loans will in many cases give taxpayers a greater tax benefit than the deduction.

EXPLANATION OF PROVISION

The bill permits taxpayers a nonrefundable personal credit for interest paid on qualified education loans during the first 60 months in which interest payments are required. The maximum annual credit available would be $500.

The credit is phased-out for single taxpayers with modified adjusted gross income between $35,000 and $45,000 and for married taxpayers filing joint returns with modified adjusted gross income between $70,000 and $90,000. These income phase-out ranges would be adjusted annually for inflation after 2009.

A taxpayer taking the credit in a taxable year for payment of interest on a qualified education loan would not be allowed a student loan interest deduction in such taxable year. Similarly, if the taxpayer took a deduction, the taxpayer would not qualify for the credit.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2008.

[40] Another section of the bill makes certain modifications to present law.

I. Compliance With Congressional Budget Act

(Secs. 441 and 442 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to education which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to education which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

V. ESTATE, GIFT, AND GENERATION-SKIPPING TRANSFER TAX PROVISIONS

A. Phaseout and Repeal of Estate and Generation-Skipping Transfer Taxes; Increase in Gift Tax Unified Credit Effective Exemption

(Secs. 501–542 of the bill, Secs. 121, 684, 1014, 1040, 1221, 2001–2210, 2501, 2502, 2503, 2505, 2511, 2601–2663, 4947, 6018, 6019, and 7701 of the Code, and new Secs. 1022, 2058, 2210, 2664, and 6716 of the Code)

PRESENT LAW

Estate and gift tax rules

In general

Under present law, a gift tax is imposed on lifetime transfers and an estate tax is imposed on transfers at death. The gift tax and the estate tax are unified so that a single graduated rate schedule applies to cumulative taxable transfers made by a taxpayer during his or her lifetime and at death. The unified estate and gift tax rates begin at 18 percent on the first $10,000 in cumulative taxable transfers and reach 55 percent on cumulative taxable transfers over $3 million. In addition, a 5-percent surtax is imposed on cumulative taxable transfers between $10 million and $17,184,000, which has the effect of phasing out the benefit of the graduated rates. Thus, these estates are subject to a top marginal rate of 60 percent. Estates over $17,184,000 are subject to a flat rate of 55 percent, as the benefit of the graduated rates has been phased out.

Gift tax annual exclusion

Donors of lifetime gifts are provided an annual exclusion of $10,000 (indexed for inflation occurring after 1997) of transfers of present interests in property to any one donee during the taxable year. If the non-donor spouse consents to split the gift with the donor spouse, then the annual exclusion is $20,000. Unlimited transfers between spouses are permitted without imposition of a gift tax.

Unified credit

A unified credit is available with respect to taxable transfers by gift and at death. The unified credit amount effectively exempts from tax transfers totaling $675,000 in 2001, $700,000 in 2002 and 2003, $850,000 in 2004, $950,000 in 2005, and $1 million in 2006 and thereafter. The benefit of the unified credit applies at the lowest estate and gift tax rates. For example, in 2001, the unified credit applies between the 18-percent and 37-percent estate and gift tax rates. Thus, in 2001, taxable transfers, after application of the unified credit, are effectively subject to estate and gift tax rates beginning at 37 percent.

Transfers to a surviving spouse

In general.—A 100-percent marital deduction generally is permitted for the value of property transferred between spouses. In addition, transfers of a "qualified terminable interest" also are eligible for the marital deduction. A "qualified terminable interest" is property: (1) which passes from the decedent, (2) in which the surviving spouse has a "qualifying income interest for life," and (3) to which an election under these rules applies. A "qualifying income interest for life" exists if: (1) the surviving spouse is entitled to all the income from the property (payable annually or at more frequent intervals) or the right to use property during the spouse's life, and (2) no person has the power to appoint any part of the property to any person other than the surviving spouse.

Transfers to surviving spouses who are not U.S. citizens.—A marital deduction generally is denied for property passing to a surviving spouse who is not a citizen of the United States. A marital deduction is permitted, however, for property passing to a qualified domestic trust of which the noncitizen surviving spouse is a beneficiary. A qualified domestic trust is a trust that has as its trustee at least one U.S. citizen or U.S. corporation. No corpus may be distributed from a qualified domestic trust unless the U.S. trustee has the right to withhold any estate tax imposed on the distribution.

There is an estate tax imposed on (1) any distribution from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse. The tax is computed as an additional estate tax on the estate of the first spouse to die.

Expenses, indebtedness, and taxes

An estate tax deduction is allowed for funeral expenses and administration expenses of an estate. An estate tax deduction also is allowed for claims against the estate and unpaid mortgages on, or any indebtedness in respect of, property for which the value of the decedent's interest therein, undiminished by the debt, is included in the value of the gross estate.

If the total amount of claims and debts against the estate exceeds the value of the property to which the claims relate, an estate tax deduction for the excess is allowed, provided such excess is paid before the due date of the estate tax return. A deduction for claims against the estate generally is permitted only if the claim is allowable by the law of the jurisdiction under which the estate is being administered.

A deduction also is allowed for the full unpaid amount of any mortgage upon, or of any other indebtedness in respect of, any property included in the gross estate (including interest which has accrued thereon to the date of the decedent's death), provided that the full value of the underlying property is included in the decedent's gross estate.

Basis of property received

In general.—A taxpayer who receives property from a decedent's estate or from a donor of a lifetime gift may want to sell or otherwise dispose of the property. Gain or loss, if any, on the disposition of the property is measured by the taxpayer's amount realized (e.g., gross proceeds received) on the disposition, less the taxpayer's basis in such property.

Basis generally represents a taxpayer's investment in property with certain adjustments required after acquisition. For example, basis is increased by the cost of capital improvements made to the property and decreased by depreciation deductions taken with respect to the property.

Property received from a donor of a lifetime gift takes a carryover basis. "Carryover basis" means that the basis in the hands of the donee is the same as it was in the hands of the donor plus any gift tax paid on any unrealized appreciation. The basis of a lifetime gift, however, generally cannot exceed the property's fair market value on the date of the gift. If the basis of the property is greater than the fair market value of the property on the date of gift, then, for purposes of determining loss, the basis is the property's fair market value on the date of gift.

Property passing from a decedent's estate generally takes a stepped-up basis. "Stepped-up basis" for estate tax purposes means that the basis of property passing from a decedent's estate generally is the fair market value on the date of the decedent's death (or, if the alternate valuation date is elected, the earlier of six months after the decedent's death or the date the property is sold or distributed by the estate). This step up (or step down) in basis eliminates the recognition of any income on the appreciation of the property that occurred prior to the decedent's death, and has the effect of eliminating the tax benefit from any unrealized loss.

Special rule for community property.—In community property states, a surviving spouse's one-half share of community property held by the decedent and the surviving spouse (under the community property laws of any State, U.S. possession, or foreign country) generally is treated as having passed from the decedent, and thus is eligible for stepped-up basis. This rule applies if at least one-half of the whole of the community interest is includible in the decedent's gross estate.

Special rules for interests in certain foreign entities.—Stepped-up basis treatment generally is denied to certain interests in foreign entities. Under present law, stock or securities in a foreign personal holding company take a carryover basis. Stock in a foreign investment company takes a stepped up basis reduced by the decedent's ratable share of accumulated earnings and profits. In addition, stock in a passive foreign investment company (including those for which a mark-to-market election has been made) generally takes a carryover basis, except that a passive foreign investment company for which a decedent shareholder had made a qualified electing fund election is allowed a stepped up basis. Stock owned by a decedent in a domestic international sales corporation (or former domestic international sales corporation) takes a stepped up basis reduced by the amount (if any) which would have been included in gross income under section 995(c) as a dividend if the decedent had lived and sold the stock at its fair market value on the estate tax valuation date (i.e., generally the date of the decedent's death unless an alternate valuation date is elected).

Provisions affecting small and family-owned businesses and farms

Special-use valuation.—An executor can elect for estate tax purposes to value certain "qualified real property" used in farming or another qualifying closely-held trade or business at its current-use value, rather than its fair market value. The maximum reduction in value for such real property is $750,000 (adjusted for inflation occurring after 1997). Real property generally can qualify for special-use valuation if at least 50 percent of the adjusted value of the decedent's gross estate consists of a farm or closely-held business assets in the decedent's estate (including both real and personal property) and at least 25 percent of the adjusted value of the gross estate consists of farm or closely-held business property. In addition, the property must be used in a qualified use (e.g., farming) by the decedent or a member of the decedent's family for five of the eight years before the decedent's death.

If, after a special-use valuation election is made, the heir who acquired the real property ceases to use it in its qualified use within 10 years of the decedent's death, an additional estate tax is imposed in order to recapture the entire estate-tax benefit of the special-use valuation.

Family-owned business deduction.—An estate is permitted to deduct the adjusted value of a qualified-family owned business interest of the decedent, up to $675,000.[41] A qualified family-owned business interest is defined as any interest in a trade or business (regardless of the form in which it is held) with a principal place of business in the United States if the decedent's family owns at least 50 percent of the trade or business, two families own 70 percent, or three families own 90 percent, as long as the decedent's family owns at least 30 percent of the trade or business. An interest in a trade or business does not qualify if any interest in the business (or a related entity) was publicly-traded at any time within three years of the decedent's death. An interest in a trade or business also does not qualify if more than 35 percent of the adjusted ordinary gross income of the business for the year of the decedent's death was personal holding company income. In the case of a trade or business that owns an interest in another trade or business (i.e., "tiered entities"), special look-through rules apply. The value of a trade or business qualifying as a family-owned business interest is reduced to the extent the business holds passive assets or excess cash or marketable securities.

To qualify for the exclusion, the decedent (or a member of the decedent's family) must have owned and materially participated in

[41] The qualified family-owned business deduction and the unified credit effective exemption amount are coordinated. If the maximum deduction amount of $675,000 is elected, then the unified credit effective exemption amount is $625,000, for a total of $1.3 million. If the qualified family-owned business deduction is less than $675,000, then the unified credit effective exemption amount is equal to $625,000, increased by the difference between $675,000 and the amount of the qualified family-owned business deduction. However, the unified credit effective exemption amount cannot be increased above the generally applicable exemption amount in effect for the taxable year.

the trade or business for at least five of the eight years preceding the decedent's date of death. In addition, at least one qualified heir (or member of the qualified heir's family) is required to materially participate in the trade or business for at least 10 years following the decedent's death.

The qualified family-owned business rules provide a graduated recapture based on the number of years after the decedent's death in which the disqualifying event occurred. Under the provision, if the disqualifying event occurred within six years of the decedent's death, then 100 percent of the tax is recaptured. The remaining percentage of recapture based on the year after the decedent's death in which a disqualifying event occurs is as follows: the disqualifying event occurs during the seventh year after the decedent's death, 80 percent; during the eighth year after the decedent's death, 60 percent; during the ninth year after the decedent's death, 40 percent; and during the tenth year after the decedent's death, 20 percent. For purposes of the qualified family-owned business deduction, the contribution of a qualified conservation easement is not considered a disposition that would trigger recapture of estate tax.

In general, there is no requirement that the qualified heir (or members of his or her family) continue to hold or participate in the trade or business more than 10 years after the decedent's death. However, the 10-year recapture period can be extended for a period of up to two years if the qualified heir does not begin to use the property for a period of up to two years after the decedent's death.

An estate can claim the benefits of both the qualified family-owned business deduction and special-use valuation. For purposes of determining whether the value of the trade or business exceeds 50 percent of the decedent's gross estate, if the estate claimed special-use valuation, then the property's special-use value is used.

State death tax credit

A credit is allowed against the Federal estate tax for any estate, inheritance, legacy, or succession taxes actually paid to any State or the District of Columbia with respect to any property included in the decedent's gross estate. The maximum amount of credit allowable for State death taxes is determined under a graduated rate table, the top rate of which is 16 percent, based on the size of the decedent's adjusted taxable estate. Most States impose a "pick-up" or "soak-up" estate tax, which serves to impose a state tax equal to the maximum Federal credit allowed.

Estate and gift taxation of nonresident noncitizens

Nonresident noncitizens are subject to gift tax with respect to certain transfers by gift of U.S.-situated property. Such property includes real estate and tangible property located within the United States. Nonresident noncitizens generally are not subject to U.S. gift tax on the transfer of intangibles, such as stock or securities, regardless of where such property is situated.

Estates of nonresident noncitizens generally are taxed at the same estate tax rates applicable to U.S. citizens, but the taxable estate includes only property situated within the United States that is owned by the decedent at death. This includes the value at death of all property, real or personal, tangible or intangible, situated in the United States. Special rules apply which treat certain property as being situated within and without the United States for these purposes.

Unless modified by a treaty, a nonresident who is not a U.S. citizen generally is allowed a unified credit of $13,000, which effectively exempts $60,000 in assets from estate tax.

Generation-skipping transfer tax

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. The generation-skipping transfer tax is imposed at a flat rate of 55 percent (i.e., the top estate and gift tax rate) on cumulative generation-skipping transfers in excess of $1 million (indexed for inflation occurring after 1997).

Selected income tax provisions

Transfers to certain foreign trusts and estates

A transfer (during life or at death) by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis (for purposes of determining gain) of such property in the hands of the transferor.

Net operating loss and capital loss carryovers

Under present law, a capital loss and net operating loss from business operations sustained by a decedent during his last taxable year are deductible only on the final return filed in his or her behalf. Such losses are not deductible by his or her estate.

Transfers of property in satisfaction of a pecuniary bequest

Under present law, gain or loss is recognized on the transfer of property in satisfaction of a pecuniary bequest (i.e., a bequest of a specific dollar amount) to the extent that the fair market value of the property at the time of the transfer exceeds the basis of the property, which generally is the basis stepped up to fair market value on the date of the decedent's death.

Income tax exclusion for the gain on the sale of a principal residence

A taxpayer generally can exclude up to $250,000 ($500,000 if married filing a joint return) of gain realized on the sale or exchange of a principal residence. The exclusion is allowed each time a taxpayer selling or exchanging a principal residence meets the eligibility requirements, but generally no more frequently than once every two years.

To be eligible, a taxpayer must have owned the residence and occupied it as a principal residence for at least two of the five years prior to the sale or exchange. A taxpayer who fails to meet these requirements by reason of a change of place of employment, health, or other unforeseen circumstances is able to exclude the fraction of the $250,000 ($500,000 if married filing a joint return) equal to the fraction of two years that these requirements are met.

Excise tax on nonexempt trusts

Under present law, non-exempt split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income, estate, or gift tax charitable deduction was allowed with respect to the trust. A non-exempt split-interest trust subject to these rules would be prohibited from engaging in self-dealing, retaining any excess business holdings, and from making certain investments or taxable expenditures. Failure to comply with the restrictions would subject the trust to certain excise taxes imposed on private foundations, which include excise taxes on self-dealing, excess business holdings, investments which jeopardize charitable purposes, and certain taxable expenditures.

REASONS FOR CHANGE

The Committee finds that the estate and generation-skipping transfer taxes are unduly burdensome on affected taxpayers, and particularly decedents' estates, decedents' heirs, and businesses, such as small business, family-owned businesses, and farming businesses. The Committee further believes that it is inappropriate to impose a tax by reason of the death of a taxpayer. In addition, the Committee believes that increasing the gift tax unified credit effective exemption amount and reducing gift tax rates will lessen the burden that gift taxes impose on all taxpayers and promote simplification for those taxpayers who would no longer be subject to the gift tax.

EXPLANATION OF PROVISION

Overview of the bill

Beginning in 2011, the estate and generation-skipping transfers taxes are repealed. After repeal, the basis of assets received from a decedent generally will equal the basis of the decedent (i.e., carryover basis) at death. However, a decedent's estate is permitted to increase the basis of assets transferred by up to a total of $1.3 million. The basis of property transferred to a surviving spouse can be increased (i.e., stepped up) by an additional $3 million. Thus, the basis of property transferred to a surviving spouse can be increased (i.e., stepped up) by a total of $4.3 million. In no case can the basis of an asset be adjusted above its fair market value. For these purposes, the executor will determine which assets and to what extent each asset receives a basis increase. The $1.3 million and $3 million amounts are adjusted annually for inflation occurring after 2010.

From 2002 and through 2010, the estate and gift tax rates are reduced, the unified credit effective exemption amount are increased (from up to $1 million for lifetime transfers in 2004 to up to $4 million for deathtime transfers in 2010), the generation-skipping transfer tax exemption amount is increased, and the state death tax credit is phased out (and repealed in 2005).

Phaseout and repeal of estate and generation-skipping transfer taxes

In general

In 2002, the 5-percent surtax (which phases out the benefit of the graduated rates) and the rates in excess of 50 percent are repealed. In addition, in 2002, the unified credit effective exemption amount (for both estate and gift tax purposes) is increased to $1 million. In 2003, the estate and gift tax rates in excess of 49 percent are repealed. In 2004, the estate and gift tax rates in excess of 48 percent are repealed, the unified credit effective exemption amount for estate tax purposes is increased to $2 million. (The unified credit effective exemption amount for gift tax purposes remains at $1 million as increased in 2002.) In addition, in 2004, the qualified family-owned business deduction is repealed. In 2005, the estate and gift tax rates in excess of 47 percent are repealed, and the unified credit effective exemption amount for estate tax purposes is increased to $3 million. In 2006, the estate and gift tax rates in excess of 46 percent are repealed. In 2007, the estate and gift tax rates in excess of 45 percent are repealed. In 2009, the unified credit effective exemption amount for estate tax purposes is increased to $3.5 million. In 2010, the unified credit effective amount for estate tax purposes is increased to $4 million.

Table 8, below, summarizes the unified credit effective exemption amounts and the highest estate and gift tax rates under the bill.

TABLE 8.—UNIFIED CREDIT EXEMPTION AMOUNTS AND HIGHEST ESTATE AND GIFT TAX RATES

[Dollars in millions]

Calendar year	Estate and GST Tax deathtime transfer exemption	Highest estate and gift tax rates (percent)
2002	$1	50
2003	1	49
2004	2	48
2005	3	47
2006	3	46
2007	3	45
2008	3	45
2009	3.5	45
2010	4	45
2011	[1] N/A	[2] 40

[1] Taxes repealed.
[2] Gift tax only.

Repeal of estate and generation-skipping transfer taxes; modifications to gift tax

The generation-skipping transfer tax exemption and tax rate for a given year (prior to repeal) be equal the unified credit effective exemption for estate tax purposes. In addition, as under present law, the generation-skipping transfer tax rate for a given year will be the highest estate and gift tax rate in effect for such year.

In 2011, the estate and generation-skipping transfer taxes are repealed. Also beginning in 2011, the top gift tax rate will be 40 percent, and, except as provided in regulations, a transfer to a trust will be treated as a taxable gift, unless the trust is treated as wholly owned by the donor or the donor's spouse under the grantor trust provisions of the Code.

Reduction in State death tax credit; deduction for State death taxes paid

From 2002 through 2004, the top State death tax credit rate is decreased from 16 percent as follows: to 8 percent in 2002, to 7.2 percent in 2003, and to 7.04 percent in 2004. In 2005, after the state death tax credit is repealed, there will be a deduction for death taxes (e.g., any estate, inheritance, legacy, or succession taxes) actually paid to any State or the District of Columbia, in respect of property included in the gross estate of the decedent. Such State taxes must have been paid and claimed before the later of: (1) four years after the filing of the estate tax return; or (2) (a) 60 days after a decision of the U.S. Tax Court determining the estate tax liability becomes final, (b) the expiration of the period of extension to pay estate taxes over time under section 6166, or (c) the expiration of the period of limitations in which to file a claim for refund or 60 days after a decision of a court in which such refund suit has been filed becomes final.

Basis of property acquired from a decedent

In general

Beginning in 2011, after the estate and generation-skipping transfer taxes have been repealed, the present-law rules providing for a fair market value basis for property acquired from a decedent are repealed. Instead, a modified carryover basis regime generally takes effect. Recipients of property transferred at the decedent's death will receive a basis equal to the lesser of the adjusted basis of the decedent or the fair market value of the property on the date of the decedent's death.

The modified carryover basis rules apply to: (1) property acquired from bequest, devise, or inheritance, or by the decedent's estate from the decedent; (2) property passing from the decedent to the extent such property passed without consideration; and (3) certain other property to which the present law rules apply.[42]

Property acquired from a decedent is treated as if the property had been acquired by gift. Thus, the character of gain on the sale of property received from a decedent's estate is carried over to the heir. For example, real estate that has been depreciated and would be subject to recapture if sold by the decedent will be subject to recapture if sold by the heir.

Property to which the modified carryover basis rules apply

The modified carryover basis rules apply to property acquired from the decedent. Property acquired from the decedent is (1) property acquired by bequest, devise, or inheritance, (2) property acquired by the decedent's estate from the decedent, (3) property transferred by the decedent to a qualified revocable trust (as defined in section 645), (4) property transferred by the decedent during his lifetime in trust with the right reserved to the decedent at

[42] Sec. 1014(b)(2) and (3).

all times before his death to make any change to the enjoyment thereof through the exercise of a power to alter, amend, or terminate the trust,[43] (5) property passing from the decedent by reason of the decedent's death to the extent such property passed without consideration (e.g., property held as joint tenants with right of survivorship or as tenants by the entireties), and (6) the surviving spouse's one-half share of certain community property held by the decedent and the surviving spouse as community property.

Basis increase for certain property

Amount of basis increase.—The bill allows an executor to increase (i.e., step up) the basis in assets owned by the decedent and acquired by the beneficiaries at death. Under this rule, each decedent's estate generally is permitted to increase (i.e., step up) the basis of assets transferred by up to a total of $1.3 million. The $1.3 million is increased by the amount of unused capital losses, net operating losses, and certain "built-in" losses of the decedent. In addition, the basis of property transferred to a surviving spouse can be increased by an additional $3 million. Thus, the basis of property transferred to surviving spouses can be increased by a total of $4.3 million. Nonresidents who are not U.S. citizens will be allowed to increase the basis of property by up to $60,000. The $60,000, $1.3 million, and $3 million amounts are adjusted annually for inflation occurring after 2010.

Property eligible for basis increase.—In general, the basis of property may be increased above the decedent's adjusted basis in that property only if the property is owned, or is treated as owned, by the decedent at the time of the decedent's death. In the case of property held as joint tenants or tenants by the entireties with the surviving spouse, one-half of the property is treated as having been owned by the decedent and is thus eligible for the basis increase. In the case of property held jointly with a person other than the surviving spouse, the portion of the property attributable to the decedent's consideration furnished is treated has having been owned by the decedent and will be eligible for a basis increase. The decedent also is treated as the owner of property (which will be eligible for a basis increase) if the property was transferred by the decedent during his lifetime to a revocable trust (as defined in section 645). The decedent also is treated as having owned the surviving spouse's one-half share of community property (which will be eligible for a basis increase) if at least one-half of the property was owned by, and acquired from, the decedent.[44] The decedent shall not, however, be treated as owning any property solely by reason of holding a power of appointment with respect to such property.

Certain property is not eligible for a basis increase. This includes: (1) property that was acquired by the decedent by gift (other than from his or her spouse) during the three-year period ending on the date of the decedent's death; (2) property that constitutes a right to receive income in respect of a decedent; (3) stock or securities of a foreign personal holding company; (4) stock of a

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[43] This is the same property the basis of which is stepped up to date of death fair market value under present law sec. 1014(b)(3).

[44] Thus, similar to the present law rule in sec. 1014(b)(6), both the decedent's and the surviving spouse's share of community property could be eligible for a basis increase.

domestic international sales corporation (or former domestic international sales corporation); (5) stock of a foreign investment company; and (6) stock of a passive foreign investment company (except for which a decedent shareholder had made a qualified electing fund election).

Rules applicable to basis increase.—Basis increase will be allocable on an asset-by-asset basis (in addition, basis increase could be allocated to a share of stock or a block of stock). However, in no case can the basis of an asset be adjusted above its fair market value. If the amount of basis increase is less than the fair market value of assets whose bases are eligible to be increased under these rules, the executor will determine which assets and to what extent each asset receives a basis increase.

Reporting requirements

Lifetime gifts

A donor is required to provide to recipients of property by gift the information relating to the property (e.g., the fair market value and basis of property) that was reported on the donor's gift tax return with respect to such property.

Transfers at death

For transfers at death of non-cash assets in excess of $1.3 million and generally for appreciated property acquired by the decedent within three years of death for which a gift tax return was required to have been filed by the donor, the executor of the estate (or the trustee of a revocable trust) would report to the IRS and any beneficiaries of the estate:

- the name and taxpayer identification number of the recipient of the property,
- an accurate description of the property,
- the adjusted basis of the property in the hands of the decedent and its fair market value at the time of death,
- the decedent's holding period for the property,
- sufficient information to determine whether any gain on the sale of the property would be treated as ordinary income,
- the amount of basis increase allocated to the property, and
- any other information as the Treasury Secretary may prescribe.

Penalties for failure to file required information

Any donor required to provide to recipients of property by gift the information relating to the property that was reported on the donor's gift tax return (e.g., the fair market value and basis of property) with respect to such property who fails to do so is liable for a penalty of $50 for each failure to report such information to a donee.

Any person required to report to the IRS transfers at death of non-cash assets in excess of $1.3 million in value who fails to do so is liable for a penalty of $10,000 for the failure to report such information. Any person required to report to the IRS the receipt by a decedent of appreciated property acquired by the decedent within three years of death for which a gift tax return was required to have been filed by the donor who fails to do so is liable for a penalty of $500 for the failure to report such information to the IRS. There also is a penalty of $50 for each failure to report such information to a beneficiary.

No penalty is imposed with respect to any failure that is due to reasonable cause. If any failure to report to the IRS or a beneficiary under the bill is due to intentional disregard of the rules, then the penalty is five percent of the fair market value of the property for which reporting was required, determined at the date of the decedent's death (for property passing at death) or determined at the time of gift (for a lifetime gift).

Certain tax benefits extending past the date for repeal of the estate tax

Prior to repeal of the estate tax, many estates may have claimed certain estate tax benefits which, upon certain events, may trigger a recapture tax or other estate tax. Because repeal of the estate tax is effective for decedents dying after December 31, 2010, these estate tax recapture provisions generally will continue to apply to estates of decedents dying before January 1, 2011.

Qualified conservation easements

A donor may have retained a development right in the conveyance of a conservation easement that qualified for the estate tax exclusion. Those with an interest in the land may later execute an agreement to extinguish the right. If an agreement to extinguish development rights is not entered into within the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement, then those with an interest in the land are personally liable for an additional tax. This provision is retained after repeal of the estate tax, which will ensure that those persons with an interest in the land who fail to execute the agreement remain liable for any additional tax which may be due after repeal.

Special-use valuation

Property may have qualified for special-use valuation prior to repeal of the estate tax. If such property ceases to qualify for special-use valuation, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate tax benefit is required to be recaptured. The recapture provision is retained after repeal of the estate tax, which will ensure that those estates that claimed this benefit prior to repeal of the estate tax will be subject to recapture if a disqualifying event occurs after repeal.

Qualified family-owned business deduction

Property may have qualified for the family-owned business deduction prior to repeal of the qualified family-owned business deduction and estate tax. If such property ceases to qualify for the family-owned business deduction, for example, because an heir ceases to use the property in its qualified use within 10 years of the decedent's death, then the estate-tax benefit is required to be recaptured. The recapture provision would be retained after repeal of the qualified family-owned business deduction and estate tax, which would ensure that those estates that claimed this benefit before repeal of the qualified family-owned business deduction and estate tax would be subject to recapture if a disqualifying event occurs after repeal.

Installment payment of estate tax for estates with an interest in a closely-held business

The present-law installment payment rules are retained so that those estates that entered into an installment payment arrangement prior to repeal of the estate tax will continue to make their payments past the date for repeal.

If more than 50 percent of the value of the closely-held business is distributed, sold, exchanged, or otherwise disposed of, the unpaid portion of the tax payable in installments must be paid upon notice and demand from the Treasury Secretary. This rule is retained after repeal of the estate tax, which will ensure that such dispositions that occur after repeal of the estate tax will continue to subject the estate to the unpaid portion of the tax upon notice and demand.

Qualified domestic trusts for noncitizen surviving spouses

Under the bill, there will continue to be an estate tax imposed on (1) any distribution prior to January 1, 2022, from a qualified domestic trust before the date of the death of the noncitizen surviving spouse and (2) the value of the property remaining in a qualified domestic trust on the date of death of the noncitizen surviving spouse if such surviving spouse dies before January 1, 2011.

Transfers to foreign trusts, foreign estates, and nonresidents who are not U.S. citizens

The present-law rule providing that a transfer (during life or at death) by a U.S. person to a foreign trust or estate generally is treated as a sale or exchange is expanded. Under the bill, a transfer by a U.S. person to a nonresident who is not a U.S. citizen is treated as a sale or exchange of the property for an amount equal to the fair market value of the transferred property. The amount of gain that must be recognized by the transferor is equal to the excess of the fair market value of the property transferred over the adjusted basis of such property in the hands of the transferor.

Transfers of property in satisfaction of a pecuniary bequest

Under the bill, gain or loss on the transfer of property in satisfaction of a pecuniary bequest is recognized only to the extent that the fair market value of the property at the time of the transfer exceeds the fair market value of the property on the date of the decedent's death (not the property's carryover basis).

Transfer of property subject to a liability

The bill clarifies that gain is not recognized at the time of death when the estate or heir acquires from the decedent property subject to a liability that is greater than the decedent's basis in the property. Similarly, no gain is recognized by the estate on the distribution of such property to a beneficiary of the estate by reason of the liability. This rule does not apply if the transfer is from the decedent's estate to a tax-exempt beneficiary, which includes (1) the United States, any State or political subdivision thereof, any U.S. possessions, any Indian tribal government, or any agency or instrumentality of the aforementioned; (2) an organization exempt from tax (other than a farmers' cooperative described in section 521); or (3) any foreign person or entity.

Income tax exclusion for the gain on the sale of a principal residence

The income tax exclusion of up to $250,000 of gain on the sale of a principal residence is extended to estates and heirs. Under the bill, if the decedent's estate or an heir sells the decedent's principal residence, $250,000 of gain can be excluded on the sale of the residence, provided the decedent used the property as a principal residence for two or more years during the five-year period prior to the sale. In addition, if an heir occupies the property as a principal residence, the decedent's period of ownership and occupancy of the property as a principal residence can be added to the heir's subsequent ownership and occupancy in determining whether the property was owned and occupied for two years as a principal residence.

Excise tax on non-exempt trusts

Under the bill, split-interest trusts are subject to certain restrictions that are applicable to private foundations if an income tax charitable deduction, including an income tax charitable deduction by an estate or trust, was allowed with respect to transfers to the trust.

EFFECTIVE DATE

The estate and gift rate reductions, increases in the estate tax unified credit exemption equivalent amounts and generation-skipping transfer tax exemption amount, and reductions in and repeal of the state death tax credit are phased-in over time, beginning with estates of decedents dying and gifts and generation-skipping transfers made after December 31, 2001. The repeal of the qualified family-owned business deduction is effective for estates of decedents dying after December 31, 2003.

The estate and generation-skipping transfer taxes are repealed, and the carryover basis regime takes effect for estates of decedents dying and generation-skipping transfers made after December 31, 2010. The provisions relating to recognition of gain on transfers to nonresidents noncitizens is effective for transfers made after December 31, 2010.

The top gift tax rate will be 40 percent, and transfers to trusts generally will be treated as a taxable gift unless the trust is treated as wholly owned by the donor or the donor's spouse, effective for gifts made after December 31, 2010.

An estate tax on distributions made from a qualified domestic trust before the date of the death of the surviving spouse will no longer apply for distributions made after December 31, 2021. An estate tax on the value of property remaining in a qualified domestic trust on the date of death of the surviving spouse will no longer apply after December 31, 2010.

B. Expand Estate Tax Rule for Conservation Easements

(Sec. 551 of the bill and Sec. 2031 of the Code)

PRESENT LAW

In general

An executor can elect to exclude from the taxable estate 40 percent of the value of any land subject to a qualified conservation easement, up to a maximum exclusion of $100,000 in 1998, $200,000 in 1999, $300,000 in 2000, $400,000 in 2001, and $500,000 in 2002 and thereafter (Sec. 2031(c)). The exclusion percentage is reduced by 2 percentage points for each percentage point (or fraction thereof) by which the value of the qualified conservation easement is less than 30 percent of the value of the land (determined without regard to the value of such easement and reduced by the value of any retained development right).

A qualified conservation easement is one that meets the following requirements: (1) the land is located within 25 miles of a metropolitan area (as defined by the Office of Management and Budget) or a national park or wilderness area, or within 10 miles of an Urban National Forest (as designated by the Forest Service of the U.S. Department of Agriculture); (2) the land has been owned by the decedent or a member of the decedent's family at all times during the three-year period ending on the date of the decedent's death; and (3) a qualified conservation contribution (within the meaning of sec. 170(h)) of a qualified real property interest (as generally defined in sec. 170(h)(2)(C)) was granted by the decedent or a member of his or her family. For purposes of the provision, preservation of a historically important land area or a certified historic structure does not qualify as a conservation purpose.

In order to qualify for the exclusion, a qualifying easement must have been granted by the decedent, a member of the decedent's family, the executor of the decedent's estate, or the trustee of a trust holding the land, no later than the date of the election. To the extent that the value of such land is excluded from the taxable estate, the basis of such land acquired at death is a carryover basis (i.e., the basis is not stepped-up to its fair market value at death). Property financed with acquisition indebtedness is eligible for this provision only to the extent of the net equity in the property.

Retained development rights

The exclusion for land subject to a conservation easement does not apply to any development right retained by the donor in the conveyance of the conservation easement. An example of such a development right would be the right to extract minerals from the land. If such development rights exist, then the value of the conservation easement must be reduced by the value of any retained development right.

If the donor or holders of the development rights agree in writing to extinguish the development rights in the land, then the value of the easement need not be reduced by the development rights. In such case, those persons with an interest in the land must execute the agreement no later than the earlier of (1) two years after the date of the decedent's death or (2) the date of the sale of such land subject to the conservation easement. If such agreement is not entered into within this time, then those with an interest in the land are personally liable for an additional tax, which is the amount of tax which would have been due on the retained development rights subject to the termination agreement.

REASONS FOR CHANGE

The Committee believes that expanding the availability of qualified conservation easements will further ease existing pressures to develop or sell environmentally significant land in order to raise funds to pay estate taxes and would, thereby, advance the preservation of such land. The Committee also believes it appropriate to clarify the date for determining easement compliance.

EXPLANATION OF PROVISION

The bill expands the availability of qualified conservation easements by eliminating the requirement that the land be located within a certain distance from a metropolitan area, national park, wilderness area, or Urban National Forest. Thus, under the bill, a qualified conservation easement may be claimed with respect to any land that is located in the United States or its possessions. The bill also clarifies that the date for determining easement compliance is the date on which the donation was made.

EFFECTIVE DATE

The provisions are effective for estates of decedents dying after December 31, 2000.

C. MODIFY GENERATION-SKIPPING TRANSFER TAX RULES

1. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips (Sec. 561 of the bill and Sec. 2632 of the Code)

PRESENT LAW

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

A direct skip is any transfer subject to estate or gift tax of an interest in property to a skip person. A skip person may be a natural person or certain trusts. All persons assigned to the second or more remote generation below the transferor are skip persons (e.g., grandchildren and great-grandchildren). Trusts are skip persons if (1) all interests in the trust are held by skip persons, or (2) no person holds an interest in the trust and at no time after the transfer may a distribution (including distributions and terminations) be made to a non-skip person.

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip).

The tax rate on generation-skipping transfers is a flat rate of tax equal to the maximum estate and gift tax rate in effect at the time of the transfer (55 percent under present law) multiplied by the "inclusion ratio." The inclusion ratio with respect to any property transferred in a generation-skipping transfer indicates the amount of "generation-skipping transfer tax exemption" allocated to a trust. The allocation of generation-skipping transfer tax exemption reduces the 55-percent tax rate on a generation-skipping transfer.

If an individual makes a direct skip during his or her lifetime, any unused generation-skipping transfer tax exemption is automatically allocated to a direct skip to the extent necessary to make the inclusion ratio for such property equal to zero. An individual can elect out of the automatic allocation for lifetime direct skips.

For lifetime transfers made to a trust that are not direct skips, the transferor must allocate generation-skipping transfer tax exemption—the allocation is not automatic. If generation-skipping transfer tax exemption is allocated on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time of the transfer. If, however, the allocation is not made on a timely-filed gift tax return, then the portion of the trust which is exempt from generation-skipping transfer tax is based on the value of the property at the time the allocation of generation-skipping transfer tax exemption was made.

Treas. Reg. sec. 26.2632–1(d) further provides that any unused generation-skipping transfer tax exemption, which has not been allocated to transfers made during an individual's life, is automatically allocated on the due date for filing the decedent's estate tax return. Unused generation-skipping transfer tax exemption is allocated pro rata on the basis of the value of the property as finally determined for estate tax purposes, first to direct skips treated as occurring at the transferor's death. The balance, if any, of unused generation-skipping transfer tax exemption is allocated pro rata, on the basis of the estate tax value of the nonexempt portion of the trust property (or in the case of trusts that are not included in the gross estate, on the basis of the date of death value of the trust) to trusts with respect to which a taxable termination may occur or from which a taxable distribution may be made.

REASONS FOR CHANGE

The Committee recognizes that there are situations where a taxpayer would desire allocation of generation-skipping transfer tax exemption, yet the taxpayer had missed allocating generation-skipping transfer tax exemption to an indirect skip, e.g., because the taxpayer or the taxpayer's advisor inadvertently omitted making the election on a timely-filed gift tax return or the taxpayer submitted a defective election. Thus, the Committee believes that automatic allocation is appropriate for transfers to a trust from which generation-skipping transfers are likely to occur.

EXPLANATION OF PROVISION

Under the bill, generation-skipping transfer tax exemption will be automatically allocated to transfers made during life that are "indirect skips." An indirect skip is any transfer of property (that is not a direct skip) subject to the gift tax that is made to a generation-skipping transfer trust.

A generation-skipping transfer trust is defined as a trust that could have a generation-skipping transfer with respect to the transferor (e.g., a taxable termination or taxable distribution), unless:

- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons (a) before the date that the individual attains age 46, (b) on or before 1 or more dates specified in the trust instrument that will occur before the date that such individual attains age 46, or (c) upon the occurrence of an event that, in accordance with regulations prescribed by the Treasury Secretary, may reasonably be expected to occur before the date that such individual attains age 46;
- the trust instrument provides that more than 25 percent of the trust corpus must be distributed to or may be withdrawn by 1 or more individuals who are non-skip persons and who are living on the date of death of another person identified in the instrument (by name or by class) who is more than 10 years older than such individuals;
- the trust instrument provides that, if 1 or more individuals who are non-skip persons die on or before a date or event described in clause (1) or (2), more than 25 percent of the trust corpus either must be distributed to the estate or estates of 1 or more of such individuals or is subject to a general power of appointment exercisable by 1 or more of such individuals;
- the trust is a trust any portion of which would be included in the gross estate of a non-skip person (other than the transferor) if such person died immediately after the transfer;
- the trust is a charitable lead annuity trust or a charitable remainder annuity trust or a charitable unitrust; or
- the trust is a trust with respect to which a deduction was allowed under section 2522 for the amount of an interest in the form of the right to receive annual payments of a fixed percentage of the net fair market value of the trust property (determined yearly) and which is required to pay principal to a non-skip person if such person is alive when the yearly payments for which the deduction was allowed terminate.

If any individual makes an indirect skip during the individual's lifetime, then any unused portion of such individual's generation-skipping transfer tax exemption is allocated to the property transferred to the extent necessary to produce the lowest possible inclusion ratio for such property.

An individual can elect not to have the automatic allocation rules apply to an indirect skip, and such elections will be deemed timely if filed on a timely-filed gift tax return for the calendar year in which the transfer was made or deemed to have been made or on such later date or dates as may be prescribed by the Treasury Secretary. An individual can elect not to have the automatic allocation rules apply to any or all transfers made by such individual to a particular trust and can elect to treat any trust as a generation-skipping transfer trust with respect to any or all transfers made by the individual to such trust, and such election can be made on a timely-filed gift tax return for the calendar year for which the election is to become effective.

EFFECTIVE DATE

The provision applies to transfers subject to estate or gift tax made after December 31, 2000, and to estate tax inclusion periods ending after December 31, 2000.

2. Retroactive allocation of the generation-skipping transfer tax exemption (Sec. 561 of the bill and Sec. 2632 of the Code)

PRESENT LAW

A taxable termination is a termination (by death, lapse of time, release of power, or otherwise) of an interest in property held in trust unless, immediately after such termination, a non-skip person has an interest in the property, or unless at no time after the termination may a distribution (including a distribution upon termination) be made from the trust to a skip person. A taxable distribution is a distribution from a trust to a skip person (other than a taxable termination or direct skip). If a transferor allocates generation-skipping transfer tax exemption to a trust prior to the taxable termination or taxable distribution, generation-skipping transfer tax may be avoided.

A transferor likely will not allocate generation-skipping transfer tax exemption to a trust that the transferor expects will benefit only non-skip persons. However, if a taxable termination occurs because, for example, the transferor's child unexpectedly dies such that the trust terminates in favor of the transferor's grandchild, and generation-skipping transfer tax exemption had not been allocated to the trust, then generation-skipping transfer tax would be due even if the transferor had unused generation-skipping transfer tax exemption.

REASONS FOR CHANGE

The Committee recognizes that when a transferor does not expect the second generation (e.g., the transferor's child) to die before the termination of a trust, the transferor likely will not allocate generation-skipping transfer tax exemption to the transfer to the trust. If a transferor knew, however, that the transferor's child might predecease the transferor and that there could be a taxable termination as a result thereof, the transferor likely would have allocated generation-skipping transfer tax exemption at the time of the transfer to the trust. The Committee believes it is appropriate to provide that when there is an unnatural order of death (e.g., when the second generation dies before the first generation transferor), the transferor can allocate generation-skipping transfer tax exemption retroactively to the date of the respective transfer to trust.

EXPLANATION OF PROVISION

Under the bill, generation-skipping transfer tax exemption can be allocated retroactively when there is an unnatural order of death. If a lineal descendant of the transferor predeceases the transferor, then the transferor can allocate any unused generation-skipping transfer exemption to any previous transfer or transfers to the trust on a chronological basis. The provision allows a transferor to retroactively allocate generation-skipping transfer exemption to a trust where a beneficiary (a) is a non-skip person, (b) is a lineal descendant of the transferor's grandparent or a grandparent of the transferor's spouse, (c) is a generation younger than the generation of the transferor, and (d) dies before the transferor. Exemption is allocated under this rule retroactively, and the applicable fraction and inclusion ratio would be determined based on the value of the property on the date that the property was transferred to trust.

EFFECTIVE DATE

The provision applies to deaths of non-skip persons occurring after December 31, 2000.

3. Severing of trusts holding property having an inclusion ratio of greater than zero (Sec. 562 of the bill and Sec. 2642 of the Code)

PRESENT LAW

A generation-skipping transfer tax generally is imposed on transfers, either directly or through a trust or similar arrangement, to a "skip person" (i.e., a beneficiary in a generation more than one generation below that of the transferor). Transfers subject to the generation-skipping transfer tax include direct skips, taxable terminations, and taxable distributions. An exemption of $1 million (indexed beginning in 1999) is provided for each person making generation-skipping transfers. The exemption can be allocated by a transferor (or his or her executor) to transferred property.

If the value of transferred property exceeds the amount of the generation-skipping transfer tax exemption allocated to that property, then the generation-skipping transfer tax generally is determined by multiplying a flat tax rate equal to the highest estate tax rate (which is currently 55 percent) by the "inclusion ratio" and the value of the taxable property at the time of the taxable event. The "inclusion ratio" is the number one minus the "applicable fraction." The applicable fraction is a fraction calculated by dividing the amount of the generation-skipping transfer tax exemption allocated to the property by the value of the property.

Under Treas. Reg. 26.2654–1(b), a trust may be severed into two or more trusts (e.g., one with an inclusion ratio of zero and one with an inclusion ratio of one) only if (1) the trust is severed according to a direction in the governing instrument or (2) the trust is severed pursuant to the trustee's discretionary powers, but only if certain other conditions are satisfied (e.g., the severance occurs or a reformation proceeding begins before the estate tax return is due). Under current Treasury regulations, however, a trustee cannot establish inclusion ratios of zero and one by severing a trust that is subject to the generation-skipping transfer tax after the trust has been created.

REASONS FOR CHANGE

Complexity can be reduced if a generation-skipping transfer trust is treated as two separate trusts for generation-skipping transfer tax purposes—one with an inclusion ratio of zero and one with an inclusion ratio of one. This result can be achieved by drafting complex documents in order to meet the specific requirements of severance. The Committee believes it is appropriate to make the rules regarding severance less burdensome and less complex.

EXPLANATION OF PROVISION

Under the bill, a trust can be severed in a "qualified severance." A qualified severance is defined as the division of a single trust and the creation of two or more trusts if (1) the single trust was divided on a fractional basis, and (2) the terms of the new trusts, in the aggregate, provide for the same succession of interests of beneficiaries as are provided in the original trust. If a trust has an inclusion ratio of greater than zero and less than one, a severance is a qualified severance only if the single trust is divided into two trusts, one of which receives a fractional share of the total value of all trust assets equal to the applicable fraction of the single trust immediately before the severance. In such case, the trust receiving such fractional share shall have an inclusion ratio of zero and the other trust shall have an inclusion ratio of one. Under the provision, a trustee may elect to sever a trust in a qualified severance at any time.

EFFECTIVE DATE

The provision is effective for severances of trusts occurring after December 31, 2000.

4. Modification of certain valuation rules (Sec. 563 of the bill and Sec. 2642 of the Code)

PRESENT LAW

Under present law, the inclusion ratio is determined using gift tax values for allocations of generation-skipping transfer tax exemption made on timely filed gift tax returns. The inclusion ratio generally is determined using estate tax values for allocations of generation-skipping transfer tax exemption made to transfers at death. Treas. Reg. 26.2642–5(b) provides that, with respect to taxable terminations and taxable distributions, the inclusion ratio becomes final on the later of the period of assessment with respect to the first transfer using the inclusion ratio or the period for assessing the estate tax with respect to the transferor's estate.

REASONS FOR CHANGE

The Committee believes it is appropriate to clarify the valuation rules relating to timely and automatic allocations of generation-skipping transfer tax exemption.

EXPLANATION OF PROVISION

Under the bill, in connection with timely and automatic allocations of generation-skipping transfer tax exemption, the value of the property for purposes of determining the inclusion ratio shall be its finally determined gift tax value or estate tax value depending on the circumstances of the transfer. In the case of a generation-skipping transfer tax exemption allocation deemed to be made at the conclusion of an estate tax inclusion period, the value for purposes of determining the inclusion ratio shall be its value at that time.

EFFECTIVE DATE

The provision is effective for transfers subject to estate or gift tax made after December 31, 2000.

5. Relief from late elections (Sec. 564 of the bill and Sec. 2642 of the Code)

PRESENT LAW

Under present law, an election to allocate generation-skipping transfer tax exemption to a specific transfer may be made at any time up to the time for filing the transferor's estate tax return. If an allocation is made on a gift tax return filed timely with respect to the transfer to trust, then the value on the date of transfer to the trust is used for determining generation-skipping transfer tax exemption allocation. However, if the allocation relating to a specific transfer is not made on a timely-filed gift tax return, then the value on the date of allocation must be used. There is no statutory provision allowing relief for an inadvertent failure to make an election on a timely-filed gift tax return to allocate generation-skipping transfer tax exemption.

REASONS FOR CHANGE

The Committee believes it is appropriate for the Treasury Secretary to grant extensions of time to make an election to allocate generation-skipping transfer tax exemption and to grant exceptions to the statutory time requirement in appropriate circumstances, e.g., when the taxpayer intended to allocate generation-skipping transfer tax exemption and the failure to timely allocate generation-skipping transfer tax exemption was inadvertent.

EXPLANATION OF PROVISION

Under the bill, the Treasury Secretary is authorized and directed to grant extensions of time to make the election to allocate generation-skipping transfer tax exemption and to grant exceptions to the time requirement, without regard to whether any period of limitations has expired. If such relief is granted, then the gift tax or estate tax value of the transfer to trust would be used for determining generation-skipping transfer tax exemption allocation.

In determining whether to grant relief for late elections, the Treasury Secretary is directed to consider all relevant circumstances, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems relevant. For purposes of determining whether to grant relief, the time for making the allocation (or election) is treated as if not expressly prescribed by statute.

EFFECTIVE DATE

The provision applies to requests pending on, or filed after, December 31, 2000. No inference is intended with respect to the availability of relief from late elections prior to the effective date of the provision.

6. Substantial compliance (Sec. 564 of the bill and Sec. 2642 of the Code)

PRESENT LAW

Under present law, there is no statutory rule which provides that substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or trust.

REASONS FOR CHANGE

The Committee recognizes that the rules and regulations regarding the allocation of generation-skipping transfer tax exemption are complex. Thus, it is often difficult for taxpayers to comply with the technical requirements for making a proper election to allocate generation-skipping transfer tax exemption. The Committee therefore believes it is appropriate to provide that generation-skipping transfer tax exemption will be allocated when a taxpayer substantially complies with the rules and regulations for allocating generation-skipping transfer tax exemption.

EXPLANATION OF PROVISION

Under the bill, substantial compliance with the statutory and regulatory requirements for allocating generation-skipping transfer tax exemption will suffice to establish that generation-skipping transfer tax exemption was allocated to a particular transfer or a particular trust. If a taxpayer demonstrates substantial compliance, then so much of the transferor's unused generation-skipping transfer tax exemption will be allocated to the extent it produces the lowest possible inclusion ratio. In determining whether there has been substantial compliance, all relevant circumstances will be considered, including evidence of intent contained in the trust instrument or instrument of transfer and such other factors as the Treasury Secretary deems appropriate.

EFFECTIVE DATE

The provision applies to transfers subject to estate or gift tax made after December 31, 2000. No inference is intended with respect to the availability of a rule of substantial compliance prior to the effective date of the provision.

D. Expand and Modify Availability of Installment Payment of Estate Tax for Closely-Held Businesses

(Secs. 571 and 572 of the bill and Sec. 6166 of the Code)

PRESENT LAW

Under present law, the estate tax generally is due within nine months of a decedent's death. However, an executor generally may elect to pay estate tax attributable to an interest in a closely-held business in 2 or more installments (but no more than 10). An estate is eligible for payment of estate tax in installments if the value of the decedent's interest in a closely-held business exceeds 35 percent of the decedent's adjusted gross estate (i.e., the gross estate less certain deductions). If the election is made, the estate may defer payment of principal and pay only interest for the first five years, followed by up to 10 annual installments of principal and interest. This provision effectively extends the time for paying estate tax by 14 years from the original due date of the estate tax.[45] A special two-percent interest rate applies to the amount of deferred estate tax attributable to the first $1 million (adjusted annually for inflation occurring after 1998) in taxable value of a closely-held business. The interest rate applicable to the amount of estate tax attributable to the taxable value of the closely-held business in excess of $1 million is equal to 45 percent of the rate applicable to underpayments of tax under section 6621 (i.e., 45 percent of the Federal short-term rate plus 3 percentage points). Interest paid on deferred estate taxes is not deductible for estate or income tax purposes.

For purposes of these rules, an interest in a closely-held business is: (1) an interest as a proprietor in a sole proprietorship, (2) an interest as a partner in a partnership carrying on a trade or business if 20 percent or more of the total capital interest of such partnership is included in the decedent's gross estate or the partnership had 15 or fewer partners, and (3) stock in a corporation carrying on a trade or business if 20 percent or more of the value of the voting stock of the corporation is included in the decedent's gross estate or such corporation had 15 or fewer shareholders. The decedent may own the interest directly or, in certain cases, ownership may be indirect, through a holding company. If ownership is through a holding company, the stock must be non-readily tradable. If stock in a holding company is treated as business company stock for purposes of the installment payment provisions, the 5-year deferral for principal and the 2-percent interest rate do not apply. The value of any interest in a closely-held business does not

[45] For example, assume estate tax is due in 2001. If interest only is paid each year for the first five years (2001 through 2005), and if 10 installments of both principal and interest are paid for the 10 years thereunder (2006 through 2015), then payment of estate tax would be extended by 14 years from the original due date of 2001.

include the value of that portion of such interest attributable to passive assets held by such business.

REASONS FOR CHANGE

The Committee finds that the present-law installment payment of estate tax provisions are restrictive and prevent estates of decedents who otherwise held an interest in a closely-held business at death from claiming the benefits of installment payment of estate tax. Thus, the Committee wishes to expand and modify availability of the provision to enable more estates of decedents with an interest in a closely-held business to claim the benefits of installment payment of estate tax.

EXPLANATION OF PROVISION

The bill expands availability of the installment payment provisions by providing that an estate of a decedent with an interest in a qualifying lending and financing business is eligible for installment payment of the estate tax. The bill also provides that an estate with an interest in a qualifying lending and financing business that claims installment payment of estate tax must make installment payments of estate tax (which will include both principal and interest) relating to the interest in a qualifying lending and financing business over five years.

The bill also clarifies that the installment payment provisions require that only the stock of holding companies, not that of operating subsidiaries, must be non-readily tradable in order to qualify for installment payment of the estate tax. The bill also provides that an estate with a qualifying property interest held through holding companies that claims installment payment of estate tax must make all installment payments of estate tax (which will include both principal and interest) relating to a qualifying property interest held through holding companies over five years.

EFFECTIVE DATE

The provision is effective for decedents dying after December 31, 2001.

E. Compliance With Congressional Budget Act

(Secs. 581 and 582 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the “Budget Act”) by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called “Byrd rule,” was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to estate, gift, and generation-skipping taxes which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to estate, gift, and generation-skipping taxes which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

VI. PENSION AND INDIVIDUAL RETIREMENT ARRANGEMENT PROVISIONS

A. INDIVIDUAL RETIREMENT ARRANGEMENTS ("IRAS")

(Secs. 601–603 of the bill and Secs. 219, 408, and 408A of the Code)

PRESENT LAW

In general

There are two general types of individual retirement arrangements ("IRAs") under present law: traditional IRAs, to which both deductible and nondeductible contributions may be made, and Roth IRAs. The Federal income tax rules regarding each type of IRA (and IRA contribution) differ.

Traditional IRAs

Under present law, an individual may make deductible contributions to an IRA up to the lesser of $2,000 or the individual's compensation if neither the individual nor the individual's spouse is an active participant in an employer-sponsored retirement plan. In the case of a married couple, deductible IRA contributions of up to $2,000 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. If the individual (or the individual's spouse) is an active participant in an employer-sponsored retirement plan, the $2,000 deduction limit is phased-out for taxpayers with adjusted gross income ("AGI") over certain levels for the taxable year.

The AGI phase-out limits for taxpayers who are active participants in employer-sponsored plans are as follows.

Taxable years beginning in	*Phase-out range*
Single Taxpayers:	
2001	$33,000–43,000
2002	34,000–44,000
2003	40,000–50,000
2004	45,000–55,000
2005 and thereafter	50,000–60,000
Joint Returns:	
2001	$53,000–63,000
2002	54,000–64,000
2003	60,000–70,000
2004	65,000–75,000
2005	70,000–80,000
2006	75,000–85,000
2007 and thereafter	80,000–100,000

The AGI phase-out range for married taxpayers filing a separate return is $0 to $10,000.

If the individual is not an active participant in an employer-sponsored retirement plan, but the individual's spouse is, the $2,000 deduction limit is phased-out for taxpayers with AGI 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.

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 withdrawal tax, unless the withdrawal is due to death or disability, is made in the form of certain periodic payments, is used to pay medical expenses in excess of 7½ percent of AGI, is used to purchase health insurance of an unemployed individual, is used for education expenses, or is used for first-time homebuyer expenses of up to $10,000.

Roth IRAs

Individuals with AGI below certain levels may make nondeductible contributions to a Roth IRA. The maximum annual contribution that may be made to a Roth IRA is the lesser of $2,000 or the individual's compensation for the year. The contribution limit is reduced to the extent an individual makes contributions to any other IRA for the same taxable year. As under the rules relating to IRAs generally, a contribution of up to $2,000 for each spouse may be made to a Roth IRA provided the combined compensation of the spouses is at least equal to the contributed amount. The maximum annual contribution that can be made to a Roth IRA is phased-out for single individuals with AGI between $95,000 and $110,000 and for joint filers with AGI between $150,000 and $160,000.

Taxpayers with modified AGI of $100,000 or less generally may convert a traditional IRA into a Roth IRA. The amount converted is includible in income as if a withdrawal had been made, except that the 10-percent early withdrawal tax does not apply and, if the conversion occurred in 1998, the income inclusion may be spread ratably over four years. Married taxpayers who file separate returns cannot convert a traditional IRA into a Roth IRA.

Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income, or subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the five-taxable year period beginning with the first taxable year for which the individual made a contribution to a Roth IRA, and (2) 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).[46] The same exceptions to the early withdrawal tax that apply to IRAs apply to Roth IRAs.

[46] Early distribution of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

Taxation of charitable contributions

Generally, a taxpayer who itemizes deductions may deduct cash contributions to charity, as well as the fair market value of contributions of property. The amount of the deduction otherwise allowable for the taxable year with respect to a charitable contribution 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.

For donations of cash by individuals, total deductible contributions to public charities may not exceed 50 percent of a taxpayer's adjusted gross income ("AGI") for a taxable year. To the extent a taxpayer has not exceeded the 50-percent limitation, contributions of cash to private foundations and certain other nonprofit organizations and contributions of capital gain property to public charities generally may be deducted up to 30 percent of the taxpayer's AGI. If a taxpayer makes a contribution in one year that exceeds the applicable 50-percent or 30-percent limitation, the excess amount of the contribution may be carried over and deducted during the next five taxable 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 adjusted annually for inflation annually for inflation. The threshold amount for 2001 is $132,950 ($66,475 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 AGI over the threshold amount, but not by more than 80 percent of itemized deductions subject to the limit. The effect of this reduction may be to limit a taxpayer's ability to deduct some of his or her charitable contributions.

REASONS FOR CHANGE

The Committee is concerned about the low national savings rate, and that individuals may not be saving adequately for retirement. The present-law IRA contribution limits have not been increased since 1981. The Committee believes that the limits should be raised in order to allow greater savings opportunities.

The Committee understands that, for a variety of reasons, older individuals may not have been saving sufficiently for retirement. For example, some individuals, especially women, may have left the workforce temporarily in order to care for children. Such individuals may have missed retirement savings options that would have been available had they remained in the workforce. Thus, the Committee believes it appropriate to accelerate the increase in the IRA contribution limits for such individuals.

EXPLANATION OF PROVISION

Increase in annual contribution limits

The provision increases the maximum annual dollar contribution limit for IRA contributions from $2,000 to $2,500 for 2002 through 2005, $3,000 for 2006 and 2007, $3,500 for 2008 and 2009, $4,000 for 2010, and $5,000 for 2011. After 2011, the limit is adjusted annually for inflation in $500 increments.

Additional catch-up contributions

The bill provides that individuals who have attained age 50 may make additional catch-up IRA contributions. The otherwise maximum contribution limit (before application of the AGI phase-out limits) for an individual who has attained age 50 before the end of the taxable year is increased by $500 for 2002 through 2005, $1000 for 2006 through 2009, $1,500 for 2010, and $2,000 for 2011 and thereafter.

Deemed IRAs under employer plans

The bill provides that, if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that (1) is established under the plan, and (2) meets the requirements applicable to either traditional IRAs or Roth IRAs, then the separate account or annuity is deemed a traditional IRA or a Roth IRA, as applicable, for all purposes of the Code. For example, the reporting requirements applicable to IRAs apply. The deemed IRA, and contributions thereto, are not subject to the Code rules pertaining to the eligible retirement plan. In addition, the deemed IRA, and contributions thereto, are not taken into account in applying such rules to any other contributions under the plan. The deemed IRA, and contributions thereto, are subject to the exclusive benefit and fiduciary rules of ERISA to the extent otherwise applicable to the plan, and are not subject to the ERISA reporting and disclosure, participation, vesting, funding, and enforcement requirements applicable to the eligible retirement plan.[47] An eligible retirement plan is a qualified plan (Sec. 401(a)), tax-sheltered annuity (Sec. 403(b)), or a governmental section 457 plan.

Tax-free IRA withdrawals for charitable purposes

The bill provides an exclusion from gross income for qualified charitable distributions from an IRA: (1) to a charitable organization (as described in sec. 170(c)) to which deductible contributions may be made; (2) to a charitable remainder annuity trust or charitable remainder unitrust; (3) to a pooled income fund (as defined in sec. 642(c)(5)); or (4) for the issuance of a charitable gift annuity. The exclusion applies with respect to distributions described in (2), (3), or (4) only if no person holds an income interest in the trust, fund, or annuity attributable to such distributions other than the IRA owner, his or her spouse, or a charitable organization.

In determining the character of distributions from a charitable remainder annuity trust or a charitable remainder unitrust to which a qualified charitable distribution from an IRA is made, the charitable remainder trust is required to treat as ordinary income the portion of the distribution from the IRA to the trust that would have been includible in income but for the provision, and as corpus any remaining portion of the distribution. Similarly, in determining

[47] The provision does not specify the treatment of deemed IRAs for purposes other than the Code and ERISA.

the amount includible in gross income by reason of a payment from a charitable gift annuity purchased with a qualified charitable distribution from an IRA, the taxpayer is not permitted to treat the portion of the distribution from the IRA that would have been taxable but for the provision and that is used to purchase the annuity as an investment in the annuity contract.

A qualified charitable distribution is any distribution from an IRA that is made after age 70½, that qualifies as a charitable contribution (within the meaning of sec. 170(c)), and that is made directly to the charitable organization or to a charitable remainder annuity trust, charitable remainder unitrust, pooled income fund, or charitable gift annuity (as described above).[48] A taxpayer is not permitted to claim a charitable contribution deduction in any year for amounts transferred from his or her IRA to a charity or to a trust, fund, or annuity that, because of the provision, are excluded from the taxpayer's income. Conversely, if the amounts transferred are otherwise nontaxable, e.g., a qualified distribution from a Roth IRA, the regularly applicable deduction rules apply.

EFFECTIVE DATE

The provision is generally effective for taxable years beginning after December 31, 2001. The provision relating to deemed IRAs under employer plans is effective for plan years beginning after December 31, 2002. The provision relating to tax-free IRA withdrawals for charitable purposes is effective for taxable years beginning after December 31, 2009.

B. Pension Provisions

1. Expanding coverage

(a) Increase in benefit and contribution limits (Sec. 611 of the bill and Secs. 401(a)(17), 402(g), 408(p), 415 and 457 of the Code)

PRESENT LAW

In general

Under present law, limits apply to contributions and benefits under qualified plans (Sec. 415), the amount of compensation that may be taken into account under a plan for determining benefits (Sec. 401(a)(17)), the maximum amount of elective deferrals that an individual may make to a salary reduction plan or tax sheltered annuity (Sec. 402(g)), and deferrals under an eligible deferred compensation plan of a tax-exempt organization or a State or local government (Sec. 457).

Limitations on contributions and benefits

Under present law, the limits on contributions and benefits under qualified plans are based on the type of plan. Under a defined contribution plan, the qualification rules limit the annual ad-

[48] It is intended that, in the case of transfer to a trust, fund, or annuity, the full amount distributed from an IRA will meet the definition of a qualified charitable distribution if the charitable organization's interest in the distribution would qualify as a charitable contribution under section 170.

ditions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $35,000 (for 2001). 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. The $35,000 limit is adjusted annually for inflation for cost-of-living adjustments in $5,000 increments.

Under a defined benefit plan, the maximum annual benefit payable at retirement is generally the lesser of (1) 100 percent of average compensation, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments.

Under present law, in general, the dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age (currently, age 65) and increased if benefits begin after social security retirement age.

Compensation limitation

Under present law, the annual compensation of each participant that may be taken into account for purposes of determining contributions and benefits under a plan, applying the deduction rules, and for nondiscrimination testing purposes is limited to $170,000 (for 2001). The compensation limit is adjusted annually for inflation for cost-of-living adjustments in $10,000 increments.

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "section 401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are adjusted annually for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,500 (for 2001) or (2) 33⅓ percent of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

REASONS FOR CHANGE

The tax benefits provided under qualified plans are a departure from the normally applicable income tax rules. The special tax benefits for qualified plans are generally justified on the ground that they serve an important social policy objective, i.e., the provision of retirement benefits to a broad group of employees. The limits on contributions and benefits, elective deferrals, and compensation that may be taken into account under a qualified plan all serve to limit the tax benefits associated with such plans. The level at which to place such limits involves a balancing of different policy objectives and a judgment as to what limits are most likely to best further policy goals.

One of the factors that may influence the decision of an employer, particularly a small employer, to adopt a plan is the extent to which the owners of the business, the decision-makers, or other highly compensated employees will benefit under the plan. The Committee believes that increasing the dollar limits on qualified plan contributions and benefits will encourage employers to establish qualified plans for their employees.

The Committee understands that, in recent years, section 401(k) plans have become increasingly more prevalent. The Committee believes it is important to increase the amount of employee elective deferrals allowed under such plans, and other plans that allow deferrals, to better enable plan participants to save for their retirement.

EXPLANATION OF PROVISION

Limits on contributions and benefits

The bill provides faster annual adjusting for inflation of the $35,000 limit on annual additions to a defined contribution plan. Under the provision this limit amount is adjusted annually for inflation in $1,000 increments.[49]

The provision increases the $140,000 annual benefit limit under a defined benefit plan to $150,000 for 2002 through 2004 and to $160,000 for 2005 and thereafter. The dollar limit is reduced for benefit commencement before age 62 and increased for benefit commencement after age 65.

Compensation limitation

The provision increases the limit on compensation that may be taken into account under a plan to $180,000 for 2002, $190,000 for 2003, and $200,000 for 2004 and 2005. After 2005, this amount is adjusted annually for inflation in $5,000 increments.

Elective deferral limitations

In 2002, the provision increases the dollar limit on annual elective deferrals under section 401(k) plans, section 403(b) annuities, and salary reduction SEPs to $11,000. In 2003 and thereafter, the limits increase in $500 annual increments until the limits reach $15,000 in 2010, with annual adjustments for inflation in $500 in-

[49] The 25 percent of compensation limitation is increased to 100 percent of compensation under another provision of the bill.

crements thereafter. The provision increases the maximum annual elective deferrals that may be made to a SIMPLE plan to $7,000 for 2002 and 2003, $8,000 for 2004 and 2005, $9,000 for 2006 and 2007, and $10,000 for 2008. After 2008, the $10,000 dollar limit is adjusted annually for inflation in $500 increments.

Section 457 plans

The dollar limit on deferrals under a section 457 plan is increased to $9,000 in 2002, and is increased in $500 annual increments thereafter until the limit reaches $11,000 in 2006. Beginning in 2007, the limit is increased in $1,000 annual increments until it reaches $15,000 in 2010. After 2010, the limit is adjusted annually for inflation thereafter in $500 increments. The limit is twice the otherwise applicable dollar limit in the three years prior to retirement.[50]

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(b) Plan loans for subchapter S shareholders, partners, and sole proprietors (Sec. 612 of the bill and Sec. 4975 of the Code)

PRESENT LAW

The Internal Revenue Code prohibits certain transactions ("prohibited transactions") between a qualified plan and a disqualified person in order to prevent persons with a close relationship to the qualified plan from using that relationship to the detriment of plan participants and beneficiaries.[51] Certain types of transactions are exempted from the prohibited transaction rules, including loans from the plan to plan participants, if certain requirements are satisfied. In addition, the Secretary of Labor can grant an administrative exemption from the prohibited transaction rules if she finds the exemption is administratively feasible, in the interest of the plan and plan participants and beneficiaries, and protective of the rights of participants and beneficiaries of the plan. Pursuant to this exemption process, the Secretary of Labor grants exemptions both with respect to specific transactions and classes of transactions.

The statutory exemptions to the prohibited transaction rules do not apply to certain transactions in which the plan makes a loan to an owner-employee.[52] Loans to participants other than owner-employees are permitted if loans are available to all participants on a reasonably equivalent basis, are not made available to highly compensated employees in an amount greater than made available to other employees, are made in accordance with specific provisions in the plan, bear a reasonable rate of interest, and are adequately secured. In addition, the Code places limits on the amount of loans and repayment terms.

[50] Another provision increases the 33⅓ percentage of compensation limit to 100 percent.

[51] Title I of the Employee Retirement Income Security Act of 1974, as amended ("ERISA"), also contains prohibited transaction rules. The Code and ERISA provisions are substantially similar, although not identical.

[52] Certain transactions involving a plan and S corporation shareholders are permitted.

For purposes of the prohibited transaction rules, an owner-employee means (1) a sole proprietor, (2) a partner who owns more than 10 percent of either the capital interest or the profits interest in the partnership, (3) an employee or officer of a Subchapter S corporation who owns more than five percent of the outstanding stock of the corporation, and (4) the owner of an individual retirement arrangement ("IRA"). The term owner-employee also includes certain family members of an owner-employee and certain corporations owned by an owner-employee.

Under the Internal Revenue Code, a two-tier excise tax is imposed on disqualified persons who engage in a prohibited transaction. The first level tax is equal to 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 equal to 100 percent of the amount involved.

REASONS FOR CHANGE

The Committee believes that the present-law prohibited transaction rules regarding loans unfairly discriminate against the owners of unincorporated businesses and S corporations. For example, under present law, the sole shareholder of a C corporation may take advantage of the statutory exemption to the prohibited transaction rules for loans, but an individual who does business as a sole proprietor may not.

EXPLANATION OF PROVISION

The provision generally eliminates the special present-law rules relating to plan loans made to an owner-employee (other than the owner of an IRA). Thus, the general statutory exemption applies to such transactions. Present law continues to apply with respect to IRAs.

EFFECTIVE DATE

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

(c) Modification of top-heavy rules (Sec. 613 of the bill and Sec. 416 of the Code)

PRESENT LAW

In general

Under present law, additional qualification requirements apply to plans that primarily benefit an employer's key employees ("top-heavy plans"). These additional requirements provide (1) more rapid vesting for plan participants who are non-key employees and (2) minimum nonintegrated employer contributions or benefits for plan participants who are non-key employees.

Definition of top-heavy plan

A defined benefit plan is a top-heavy plan if more than 60 percent of the cumulative accrued benefits under the plan are for key employees. A defined contribution plan is top heavy if the sum of the account balances of key employees is more than 60 percent of the total account balances under the plan. For each plan year, the determination of top-heavy status generally is made as of the last day of the preceding plan year ("the determination date").

For purposes of determining whether a plan is a top-heavy plan, benefits derived both from employer and employee contributions, including employee elective contributions, are taken into account. In addition, the accrued benefit of a participant in a defined benefit plan and the account balance of a participant in a defined contribution plan includes any amount distributed within the 5-year period ending on the determination date.

An individual's accrued benefit or account balance is not taken into account in determining whether a plan is top-heavy if the individual has not performed services for the employer during the 5-year period ending on the determination date.

In some cases, two or more plans of a single employer must be aggregated for purposes of determining whether the group of plans is top-heavy. The following plans must be aggregated: (1) plans which cover a key employee (including collectively bargained plans); and (2) any plan upon which a plan covering a key employee depends for purposes of satisfying the Code's nondiscrimination rules. The employer may be required to include terminated plans in the required aggregation group. In some circumstances, an employer may elect to aggregate plans for purposes of determining whether they are top heavy.

SIMPLE plans are not subject to the top-heavy rules.

Definition of key employee

A key employee is an employee who, during the plan year that ends on the determination date or any of the four preceding plan years, is (1) an officer earning over one-half of the defined benefit plan dollar limitation of section 415 ($70,000 for 2001), (2) a 5-percent owner of the employer, (3) a 1-percent owner of the employer earning over $150,000, or (4) one of the 10 employees earning more than the defined contribution plan dollar limit ($35,000 for 2001) with the largest ownership interests in the employer. A family ownership attribution rule applies to the determination of 1-percent owner status, 5-percent owner status, and largest ownership interest. Under this attribution rule, an individual is treated as owning stock owned by the individual's spouse, children, grandchildren, or parents.

Minimum benefit for non-key employees

A minimum benefit generally must be provided to all non-key employees in a top-heavy plan. In general, a top-heavy defined benefit plan must provide a minimum benefit equal to the lesser of (1) two percent of compensation multiplied by the employee's years of service, or (2) 20 percent of compensation. A top-heavy defined contribution plan must provide a minimum annual contribution equal to the lesser of (1) three percent of compensation, or (2) the percentage of compensation at which contributions were made for key employees (including employee elective contributions made by key employees and employer matching contributions).

For purposes of the minimum benefit rules, only benefits derived from employer contributions (other than amounts employees have elected to defer) to the plan are taken into account, and an employee's social security benefits are disregarded (i.e., the minimum benefit is nonintegrated). Employer matching contributions may be used to satisfy the minimum contribution requirement; however, in such a case the contributions are not treated as matching contributions for purposes of applying the special nondiscrimination requirements applicable to employee elective contributions and matching contributions under sections 401(k) and (m). Thus, such contributions would have to meet the general nondiscrimination test of section 401(a)(4).[53]

Top-heavy vesting

Benefits under a top-heavy plan must vest at least as rapidly as under one of the following schedules: (1) three-year cliff vesting, which provides for 100 percent vesting after three years of service; and (2) two-six year graduated vesting, which provides for 20 percent vesting after two years of service, and 20 percent more each year thereafter so that a participant is fully vested after six years of service.[54]

Qualified cash or deferred arrangements

Under a qualified cash or deferred arrangement (a "section 401(k) plan"), an employee may elect to have the employer make payments as contributions to a qualified plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. A special nondiscrimination test applies to elective deferrals under cash or deferred arrangements, which compares the elective deferrals of highly compensated employees with elective deferrals of nonhighly compensated employees. (This test is called the actual deferral percentage test or the "ADP" test). Employer matching contributions under qualified defined contribution plans are also subject to a similar nondiscrimination test. (This test is called the actual contribution percentage test or the "ACP" test.)

Under a design-based safe harbor, a cash or deferred arrangement is deemed to satisfy the ADP test if the plan satisfies one of two contribution requirements and satisfies a notice requirement. A plan satisfies the contribution requirement under the safe harbor rule for qualified cash or deferred arrangements 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 without regard to the permitted disparity rules (Sec. 401(1)). A plan 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 employ-

[53] Treas. Reg. sec. 1.416–1 Q&A M–19.

[54] Benefits under a plan that is not top heavy must vest at least as rapidly as under one of the following schedules: (1) five-year cliff vesting; and (2) three-seven year graded vesting, which provides for 20 percent vesting after three years and 20 percent more each year thereafter so that a participant is fully vested after seven years of service.

ee's elective deferrals from three to five percent of compensation; and (2), the rate of match with respect to any elective contribution for highly compensated employees is not greater than the rate of match for nonhighly compensated employees. Matching contributions that satisfy the design-based safe harbor for cash or deferred arrangements are deemed to satisfy the ACP test. Certain additional matching contributions are also deemed to satisfy the ACP test.

REASONS FOR CHANGE

The top-heavy rules primarily affect the plans of small employers. While the top-heavy rules were intended to provide additional minimum benefits to rank-and-file employees, the Committee is concerned that in some cases the top-heavy rules may act as a deterrent to the establishment of a plan by a small employer. The Committee believes that simplification of the top-heavy rules will help alleviate the additional administrative burdens the rules place on small employers. The Committee also believes that, in applying the top-heavy minimum benefit rules, the employer should receive credit for all contributions the employer makes, including matching contributions.

EXPLANATION OF PROVISION

Definition of top-heavy plan

In determining whether a plan is top-heavy, the bill provides that distributions during the year ending on the date the top-heavy determination is being made are taken into account. The present-law 5-year rule applies with respect to in-service distributions. Similarly, the bill provides that an individual's accrued benefit or account balance is not taken into account if the individual has not performed services for the employer during the 1-year period ending on the date the top-heavy determination is being made.

Definition of key employee

The bill (1) provides that an employee is not considered a key employee by reason of officer status unless the employee earns more than the compensation limit for determining whether an employee is highly compensated ($85,000 for 2001)[55] and (2) repeals the top-10 owner key employee category. The provision repeals the 4-year lookback rule for determining key employee status and provides that an employee is a key employee only if he or she is a key employee during the preceding plan year. An employee who was not an employee in the preceding plan year, or who was an employee only for part of the year, is treated as a key employee if it can be reasonably anticipated that the employee will meet the definition of a key employee for the current plan year.

Thus, under the provision, an employee generally is considered a key employee if, during the prior year, the employee was (1) an officer with compensation in excess of $85,000, (2) a 5-percent owner, or (3) a 1-percent owner with compensation in excess of

[55] The compensation limit is determined without regard to the top-paid group election.

$150,000. The present-law limits on the number of officers treated as key employees under (1) continue to apply.

Minimum benefit for nonkey employees

Under the provision, matching contributions are taken into account in determining whether the minimum benefit requirement has been satisfied.[56]

The bill provides that, in determining the minimum benefit required under a defined benefit plan, a year of service does not include any year in which no key employee or former key employee benefits under the plan (as determined under sec. 410).

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(d) Elective deferrals not taken into account for purposes of deduction limits (Sec. 614 of the bill and Sec. 404 of the Code)

PRESENT LAW

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

For purposes of the deduction limits, employee elective deferral contributions to a section 401(k) plan are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.

Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

[56] Thus, this provision overrides the provision in Treasury regulations that, if matching contributions are used to satisfy the minimum benefit requirement, then they are not treated as matching contributions for purposes of the section 401(m) nondiscrimination rules.

REASONS FOR CHANGE

Subjecting elective deferrals to the normally applicable deduction limits may cause employers to restrict the amount of elective deferrals an employee may make or to restrict employer contributions to the plan, thereby reducing participants' ultimate retirement benefits and their ability to save adequately for retirement. The Committee believes that the amount of elective deferrals otherwise allowable should not be further limited through application of the deduction rules.

EXPLANATION OF PROVISION

Under the provision, the applicable percentage of elective deferral contributions is not subject to the deduction limits, and the application of a deduction limitation to any other employer contribution to a qualified retirement plan does not take into account the applicable percentage of elective deferral contributions. The applicable percentage is 25 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(e) Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations (Sec. 615 of the bill and Sec. 457 of the Code)

PRESENT LAW

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local government employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33⅓ percent of compensation. The $8,500 limit is increased for inflation in $500 increments. Under a special catch-up rule, a section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

The $8,500 limit (as modified under the catch-up rule), applies to all deferrals under all section 457 plans in which the individual participates. In addition, in applying the $8,500 limit, contributions under a tax-sheltered annuity ("section 403(b) annuity"), elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), salary reduction contributions under a simplified employee pension plan ("SEP"), and contributions under a SIMPLE plan are taken into account. Further, the amount deferred under a section 457 plan is taken into account in applying a special catch-up rule for section 403(b) annuities.

REASONS FOR CHANGE

The Committee believes that individuals participating in a section 457 plan should also be able to fully participate in a section 403(b) annuity or section 401(k) plan of the employer. Eliminating the coordination rule may also encourage the establishment of section 403(b) or 401(k) plans by tax-exempt and governmental employers (to the extent permitted under present law).

EXPLANATION OF PROVISION

The provision repeals the rules coordinating the section 457 dollar limit with contributions under other types of plans.[57]

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(f) Deduction limits (Sec. 616 of the bill and Sec. 404 of the Code)

PRESENT LAW

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, the deduction limit depends on the kind of plan. Subject to certain exceptions, nondeductible contributions are subject to a 10-percent excise tax.

In the case of a defined benefit pension plan or a money purchase pension plan, the employer generally may deduct the amount necessary to satisfy the minimum funding cost of the plan for the year. If a defined benefit pension plan has more than 100 participants, the maximum amount deductible is at least equal to the plan's unfunded current liabilities.

In some cases, the amount of deductible contributions is limited by compensation. In the case of a profit-sharing or stock bonus plan, the employer generally may deduct an amount equal to 15 percent of compensation of the employees covered by the plan for the year.

If an employer sponsors both a defined benefit pension plan and a defined contribution plan that covers some of the same employees (or a money purchase pension plan and another kind of defined contribution plan), the total deduction for all plans for a plan year generally is limited to the greater of (1) 25 percent of compensation or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year (or the amount of the plan's unfunded current liabilities, in the case of a plan with more than 100 participants).

In the case of an employee stock ownership plan ("ESOP"), principal payments on a loan used to acquire qualifying employer securities are deductible up to 25 percent of compensation.

For purposes of the deduction limits, employee elective deferral contributions to a qualified cash or deferred arrangement ("section

[57] The limits on deferrals under a section 457 plan are modified under other provisions of the provision.

401(k) plan") are treated as employer contributions and, thus, are subject to the generally applicable deduction limits.[58]

For purposes of the deduction limits, compensation means the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the plan, and the beneficiaries under a profit-sharing or stock bonus plan are the employees who benefit under the plan with respect to the employer's contribution.[59] An employee who is eligible to make elective deferrals under a section 401(k) plan is treated as benefiting under the arrangement even if the employee elects not to defer.[60]

For purposes of the deduction rules, compensation generally includes only taxable compensation, and thus does not include salary reduction amounts, such as elective deferrals under a section 401(k) plan or a tax-sheltered annuity ("section 403(b) annuity"), elective contributions under a deferred compensation plan of a tax-exempt organization or a State or local government ("section 457 plan"), and salary reduction contributions under a section 125 cafeteria plan. For purposes of the contribution limits under section 415, compensation does include such salary reduction amounts.

REASONS FOR CHANGE

The Committee believes that compensation unreduced by employee elective contributions is a more appropriate measure of compensation for qualified retirement plan purposes, including deduction limits, than the present-law rule. Applying the same definition for deduction purposes as is generally used for other plan purposes will also simplify application of the qualified plan rules. The Committee also believes that the 15 percent of compensation limit may restrict the amount of employer contributions to the plan, thereby reducing participants' ultimate retirement benefits and their ability to adequately save for retirement.

EXPLANATION OF PROVISION

Under the provision, the definition of compensation for purposes of the deduction rules includes salary reduction amounts treated as compensation under section 415. In addition, the annual limitation on the amount of deductible contributions to a profit-sharing or stock bonus plan is increased from 15 percent to 25 percent of compensation of the employees covered by the plan for the year. Also, except to the extent provided in regulations, a money purchase pension plan is treated like a profit-sharing or stock bonus plan for purposes of the deduction rules.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

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[58] Another provision of the bill provides that elective deferrals are not subject to the deduction limits.

[59] Rev. Rul. 65–295, 1965–2 C.B. 148.

[60] Treas. Reg. sec. 1.410(b)–3.

(g) Option to treat elective deferrals as after-tax Roth contributions (Sec. 617 of the bill and new Sec. 402A of the Code)

PRESENT LAW

A qualified cash or deferred arrangement ("section 401(k) plan") or a tax-sheltered annuity ("section 403(b) annuity") may permit a participant to elect to have the employer make payments as contributions to the plan or to the participant directly in cash. Contributions made to the plan at the election of a participant are elective deferrals. Elective deferrals must be nonforfeitable and are subject to an annual dollar limitation (Sec. 402(g)) and distribution restrictions. In addition, elective deferrals under a section 401(k) plan are subject to special nondiscrimination rules. Elective deferrals (and earnings attributable thereto) are not includible in a participant's gross income until distributed from the plan.

Elective deferrals for a taxable year that exceed the annual dollar limitation ("excess deferrals") are includible in gross income for the taxable year. If an employee makes elective deferrals under a plan (or plans) of a single employer that exceed the annual dollar limitation ("excess deferrals"), then the plan may provide for the distribution of the excess deferrals, with earnings thereon. If the excess deferrals are made to more than one plan of unrelated employers, then the plan may permit the individual to allocate excess deferrals among the various plans, no later than the March 1 (April 15 under the applicable regulations) following the end of the taxable year. If excess deferrals are distributed not later than April 15 following the end of the taxable year, along with earnings attributable to the excess deferrals, then the excess deferrals are not again includible in income when distributed. The earnings are includible in income in the year distributed. If excess deferrals (and income thereon) are not distributed by the applicable April 15, then the excess deferrals (and income thereon) are includible in income when received by the participant. Thus, excess deferrals that are not distributed by the applicable April 15th are taxable both in the taxable year when the deferral was made and in the year the participant receives a distribution of the excess deferral.

Individuals with adjusted gross income below certain levels generally may make nondeductible contributions to a Roth IRA and may convert a deductible or nondeductible IRA into a Roth IRA. Amounts held in a Roth IRA that are withdrawn as a qualified distribution are not includible in income and are not subject to the additional 10-percent tax on early withdrawals. A qualified distribution is a distribution that (1) is made after the 5-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, is made on account of death or disability, or is a qualified special purpose distribution (i.e., for first-time homebuyer expenses of up to $10,000). A distribution from a Roth IRA that is not a qualified distribution is includible in income to the extent attributable to earnings, and is subject to the 10-percent tax on early withdrawals (unless an exception applies).[61]

REASONS FOR CHANGE

The recently-enacted Roth IRA provisions have provided individuals with another form of tax-favored retirement savings. For a variety of reasons, some individuals may prefer to save through a Roth IRA rather than a traditional deductible IRA. The Committee believes that similar savings choices should be available to participants in section 401(k) plans and tax-sheltered annuities.

EXPLANATION OF PROVISION

A section 401(k) plan or a section 403(b) annuity is permitted to include a "Roth contribution program" that permits a participant to elect to have all or a portion of the participant's elective deferrals under the plan treated as Roth contributions. Roth contributions are elective deferrals that the participant designates (at such time and in such manner as the Secretary may prescribe)[62] as not excludable from the participant's gross income.

The annual dollar limitation on a participant's Roth contributions is the section 402(g) annual limitation on elective deferrals, reduced by the participant's elective deferrals that the participant does not designate as Roth contributions. Roth contributions are treated as any other elective deferral for purposes of nonforfeitability requirements and distribution restrictions.[63] Under a section 401(k) plan, Roth contributions also are treated as any other elective deferral for purposes of the special nondiscrimination requirements.[64]

The plan is required to establish a separate account, and maintain separate recordkeeping, for a participant's Roth contributions (and earnings allocable thereto). A qualified distribution from a participant's Roth contribution account is not includible in the participant's gross income. A qualified distribution is a distribution that is made after the end of a specified nonexclusion period and that is (1) made on or after the date on which the participant attains age 59½, (2) made to a beneficiary (or to the estate of the participant) on or after the death of the participant, or (3) attributable to the participant being disabled.[65] The nonexclusion period is the 5-year-taxable period beginning with the earlier of (1) the first taxable year for which the participant made a Roth contribution to any Roth contribution account established for the participant under the plan, or (2) if the participant has made a rollover

[61] Early distributions of converted amounts may also accelerate income inclusion of converted amounts that are taxable under the 4-year rule applicable to 1998 conversions.

[62] It is intended that the Secretary generally will not permit retroactive designations of elective deferrals as Roth contributions.

[63] Similarly, Roth contributions to a section 403(b) annuity are treated the same as other salary reduction contributions to the annuity (except that Roth contributions would be includible in income).

[64] It is intended that the Secretary will provide ordering rules regarding the return of excess contributions under the special nondiscrimination rules (pursuant to sec. 401(k)(8)) in the event a participant makes both regular elective deferrals and Roth contributions. It is intended that such rules will generally permit a plan to allow participants to designate which contributions would be returned first or to permit the plan to specify which contributions will be returned first.

[65] A qualified special purpose distribution, as defined under the rules relating to Roth IRAs, does not qualify as a tax-free distribution from a Roth contribution account.

contribution to the Roth contribution account that is the source of the distribution from a Roth contribution account established for the participant under another plan, the first taxable year for which the participant made a Roth contribution to the previously established account.

A distribution from a Roth contribution account that is a corrective distribution of an elective deferral (and income allocable thereto) that exceeds the section 402(g) annual limit on elective deferrals or a corrective distribution of an excess contribution under the special nondiscrimination rules (pursuant to sec. 401(k)(8) (and income allocable thereto) is not a qualified distribution. In addition, the treatment of excess Roth contributions is similar to the treatment of excess deferrals attributable to non-Roth contributions. If excess Roth contributions (including earnings thereon) are distributed no later than the April 15th following the taxable year, then the Roth contributions are not includible in gross income as a result of the distribution, because such contributions are includible in gross income when made. Earnings on such excess Roth contributions are treated the same as earnings on excess deferrals distributed no later than April 15th, i.e., they are includible in income when distributed. If excess Roth contributions are not distributed no later than the applicable April 15th, then such contributions (and earnings thereon) are taxable when distributed. Thus, as is the case with excess elective deferrals that are not distributed by the applicable April 15th, the contributions are includible in income in the year when made and again when distributed from the plan. Earnings on such contributions are taxable when received.

A participant is permitted to roll over a distribution from a Roth contribution account only to another Roth contribution account or a Roth IRA of the participant.

The Secretary of the Treasury is directed to require the plan administrator of each section 401(k) plan or section 403(b) annuity that permits participants to make Roth contributions to make such returns and reports regarding Roth contributions to the Secretary, plan participants and beneficiaries, and other persons that the Secretary may designate.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2003.

(h) Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (Sec. 618 of the bill and new Sec. 25C of the Code)

PRESENT LAW

Present law provides favorable tax treatment for a variety of retirement savings vehicles, including employer-sponsored retirement plans and individual retirement arrangements (“IRAs”).

Several different types of tax-favored employer-sponsored retirement plans exist, such as section 401(a) qualified plans (including plans with a section 401(k) qualified cash-or-deferred arrangement), section 403(a) qualified annuity plans, section 403(b) annuities, section 408(k) simplified employee pensions (“SEPs”), section

408(p) SIMPLE retirement accounts, and section 457(b) eligible deferred compensation plans. In general, an employer and, in certain cases, employees, contribute to the plan. Taxation of the contributions and earnings thereon is generally deferred until benefits are distributed from the plan to participants or their beneficiaries.[66] Contributions and benefits under tax-favored employer-sponsored retirement plans are subject to specific limitations.

Coverage and nondiscrimination rules also generally apply to tax-favored employer-sponsored retirement plans to ensure that plans do not disproportionately cover higher-paid employees and that benefits provided to moderate- and lower-paid employees are generally proportional to those provided to higher-paid employees.

IRAs include both traditional IRAs and Roth IRAs. In general, an individual makes contributions to an IRA, and investment earnings on those contributions accumulate on a tax-deferred basis. Total annual IRA contributions per individual are limited to $2,000 (or the compensation of the individual or the individual's spouse, if smaller). Contributions to a traditional IRA may be deducted from gross income if an individual's adjusted gross income ("AGI") is below certain levels or the individual is not an active participant in certain employer-sponsored retirement plans. Contributions to a Roth IRA are not deductible from gross income, regardless of adjusted gross income. A distribution from a traditional IRA is includible in the individual's gross income except to the extent of individual contributions made on a nondeductible basis. A qualified distribution from a Roth IRA is excludable from gross income.

Taxable distributions made from employer retirement plans and IRAs before the employee or individual has reached age 59½ are subject to a 10-percent additional tax, unless an exception applies.

REASONS FOR CHANGE

The Committee recognizes that the rate of private savings in the United States is low; in particular many low- and middle-income individuals have inadequate savings or no savings at all. A key reason for these low levels of saving is that lower-income families are likely to be more budget constrained with competing needs such as food, clothing, shelter, and medical care taking a larger portion of their income. The Committee believes providing an additional tax incentive for low- and middle-income individuals will enhance their ability to save adequately for retirement.

EXPLANATION OF PROVISION

The bill provides a temporary nonrefundable tax credit for contributions made by eligible taxpayers to a qualified plan. The maximum annual contribution eligible for the credit is $2,000. The credit rate depends on the adjusted gross income ("AGI") of the taxpayer. Only 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

[66] In the case of after-tax employee contributions, only earnings are taxed upon withdrawal.

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 elective contributions to a section 401(k) plan, section 403(b) annuity, or eligible deferred compensation arrangement of a State or local government (a "sec. 457 plan"), SIMPLE, or SEP, contributions to a traditional or Roth IRA, and voluntary after-tax employee contributions to a qualified retirement plan. The present-law rules governing such contributions continue to apply.

The amount of any contribution eligible for the credit is reduced by taxable distributions received by the taxpayer and his or her spouse from any savings arrangement described above or any other qualified retirement plan 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 and prior to the due date for filing the taxpayer's return for the year. In the case of a distribution from a Roth IRA, this rule applies to any such distributions, whether or not taxable.

The credit rates based on AGI are as follows.

Joint filers	Heads of households	All other filers	Credit rate (percent)
$0–$30,000	$0–$22,500	$0–$15,000	50
$30,000–$32,500	$22,500–$24,375	$15,000–$16,250	20
$32,500–$50,000	$24,375–$37,500	$16,250–$25,000	10
Over $50,000	Over $37,500	Over $25,000	0

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001, and before January 1, 2007.

(i) Small business tax credit for qualified retirement plan contributions (Sec. 619 of the bill and new Sec. 45E of the Code)

PRESENT LAW

The timing of an employer's deduction for compensation paid to an employee generally corresponds to the employee's recognition of the compensation. However, an employer that contributes to a qualified retirement plan is entitled to a deduction (within certain limits) for the employer's contribution to the plan on behalf of an employee even though the employee does not recognize income with respect to the contribution until the amount is distributed to the employee.

REASONS FOR CHANGE

The Committee understands that many small employers are reluctant to establish a qualified retirement plan that provides nonelective or matching contributions to all employees. Plans that offer only salary reduction contributions may not provide sufficient incentive for lower- and middle-income employees to save. The Committee believes that providing a credit for employers who provide nonelective and matching contributions for nonhighly compensated employees will result in greater retirement saving for such employees.

EXPLANATION OF PROVISION

The bill provides a nonrefundable income tax credit for small employers equal to 50 percent of certain qualifying employer contributions made to qualified retirement plans on behalf of nonhighly compensated employees. The credit is not available with respect to contributions to a SIMPLE IRA or SEP. For purposes of the provision, a small employer means an employer with no more than 20 employees who received at least $5,000 of earnings in the preceding year. A nonhighly compensated employee is defined as an employee who neither (1) was a five-percent owner of the employer at any time during the current year or the preceding year, or (2) for the preceding year, had compensation in excess of $80,000 (adjusted annually for inflation, this amount is $85,000 for 2001).[67] The credit is available for the first three plan years of the plan.

The provision requires a small employer to make nonelective contributions equal to at least one percent of compensation to qualify for the credit. The credit applies to both qualifying nonelective employer contributions and qualifying employer matching contributions, but only up to a total of three percent of the nonhighly compensated employee's compensation. The credit is available for 50 percent of qualifying benefit accruals under a nonintegrated defined benefit plan if the benefits are equivalent, as defined in regulations, to a three-percent nonelective contribution to a defined contribution plan.

To qualify for the credit, the nonelective and matching contributions to a defined contribution plan and the benefit accruals under a defined benefit plan are required to vest at least as rapidly as under either a three-year cliff vesting schedule or a graded schedule that provides 20-percent vesting per year for five years. In order to qualify for the credit, contributions to plans other than pension plans must be subject to the same distribution restrictions that apply to qualified nonelective employer contributions to a section 401(k) plan, i.e., distribution only upon separation from service, death, disability, attainment of age 59½, plan termination without a successor plan, or acquisition of a subsidiary or substantially all the assets of a trade or business that employs the participant.[68] Qualifying contributions to pension plans are subject to the distribution restrictions applicable to such plans.

A defined contribution plan to which the small employer makes the qualifying contributions (and any plan aggregated with that plan for nondiscrimination testing purposes) is required to allocate any nonelective employer contributions proportionally to participants' compensation from the employer (or on a flat-dollar basis)

[67] The top paid group election, which under present law permits an employer to classify an employee as a nonhighly compensated employee if the employee had compensation in excess of $80,000 (adjusted annually for inflation) during the preceding year but was not among the top 20 percent of employees of the employer when ranked on the basis of compensation paid to employees during the preceding year, is not taken into account in determining nonhighly compensated employees for purposes of the provision.

[68] The rules relating to distribution upon separation from service are modified under another provision of the bill.

and, accordingly, without the use of permitted disparity or cross-testing. An equivalent requirement must be met with respect to a defined benefit plan.

Forfeited nonvested qualifying contributions or accruals for which the credit was claimed generally result in recapture of the credit at a rate of 35 percent. However, recapture does not apply to the extent that forfeitures of contributions are reallocated to nonhighly compensated employees or applied to future contributions on behalf of nonhighly compensated employees. The Secretary of the Treasury is authorized to issue administrative guidance, including de minimis rules, to simplify or facilitate claiming and recapturing the credit.

The credit is a general business credit.[69] The 50 percent of qualifying contributions that are effectively offset by the tax credit are not deductible; the other 50 percent of the qualifying contributions (and other contributions) are deductible to the extent permitted under present law.

EFFECTIVE DATE

The credit is effective with respect to contributions paid or incurred in taxable years beginning after December 31, 2002, with respect to plans established after such date.

(j) Small business tax credit for new retirement plan expenses (Sec. 620 of the bill and new Sec. 45F of the Code)

PRESENT LAW

The costs incurred by an employer related to the establishment and maintenance of a retirement plan (e.g., payroll system changes, investment vehicle set-up fees, consulting fees) generally are deductible by the employer as ordinary and necessary expenses in carrying on a trade or business.

REASONS FOR CHANGE

One of the reasons some small employers may not adopt a tax-favored retirement plan is the administrative costs associated with such plans. The Committee believes that providing a tax credit for certain administrative costs will reduce one of the barriers to retirement plan coverage.

EXPLANATION OF PROVISION

The bill provides a nonrefundable income tax credit for 50 percent of the administrative and retirement-education expenses for any small business that adopts a new qualified defined benefit or defined contribution plan (including a section 401(k) plan), SIMPLE plan, or simplified employee pension ("SEP"). The credit applies to 50 percent of the first $1,000 in administrative and retirement-education expenses for the plan for each of the first three years of the plan.

The credit is available to an employer that did not employ, in the preceding year, more than 100 employees with compensation in ex-

[69] The credit cannot be carried back to years before the effective date.

cess of $5,000. In order for an employer to be eligible for the credit, the plan must cover at least one nonhighly compensated employee. In addition, if the credit is for the cost of a payroll deduction IRA arrangement, the arrangement must be made available to all employees of the employer who have worked with the employer for at least three months.

The credit is a general business credit.[70] The 50 percent of qualifying expenses that are effectively offset by the tax credit are not deductible; the other 50 percent of the qualifying expenses (and other expenses) are deductible to the extent permitted under present law.

EFFECTIVE DATE

The credit is effective with respect to costs paid or incurred in taxable years beginning after December 31, 2001, with respect to plans established after such date.

(k) Eliminate IRS user fees for certain determination letter requests regarding employer plans (Sec. 621 of the bill)

PRESENT LAW

An employer that maintains a retirement plan for the benefit of its employees may request from the Internal Revenue Service ("IRS") a determination as to whether the form of the plan satisfies the requirements applicable to tax-qualified plans (Sec. 401(a)). In order to obtain from the IRS a determination letter on the qualified status of the plan, the employer must pay a user fee. The user fee may range from $125 to $1,250, depending upon the scope of the request and the type and format of the plan.[71]

Present law provides that plans that do not meet the qualification requirements will be treated as meeting such requirements if appropriate retroactive plan amendments are made during the remedial amendment period. In general, the remedial amendment period ends on the due date for the employer's tax return (including extensions) for the taxable year in which the event giving rise to the disqualifying provision occurred (e.g., a plan amendment or a change in the law). The Secretary may provide for general extensions of the remedial amendment period or for extensions in certain cases. For example, the remedial amendment period with respect to amendments relating to the qualification requirements affected by the General Agreements on Tariffs and Trade, the Uniformed Services Employment and Reemployment Rights Act of 1994, the Small Business Job Protection Act of 1996, the Taxpayer Relief Act of 1997, and the Internal Revenue Service Restructuring and Reform Act of 1998 generally ends the last day of the first plan year beginning on or after January 1, 2001.[72]

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[70] The credit cannot be carried back to years before the effective date.

[71] Authorization for the user fees was originally enacted in section 10511 of the Revenue Act of 1987 (Pub. L. No. 100–203, December 22, 1987). The authorization was extended through September 30, 2003, by Public Law Number 104–117 (An Act to provide that members of the Armed Forces performing services for the peacekeeping efforts in Bosnia and Herzegovina, Croatia, and Macedonia shall be entitled to tax benefits in the same manner as if such services were performed in a combat zone, and for other purposes (March 20, 1996)).

[72] Rev. Proc. 2000–27, 2000–26 I.R.B. 1272.

REASONS FOR CHANGE

One of the factors affecting the decision of a small employer to adopt a plan is the level of administrative costs associated with the plan. The Committee believes that reducing administrative costs, such as IRS user fees, will help further the establishment of qualified plans by small employers.

EXPLANATION OF PROVISION

An eligible employer is not required to pay a user fee for a determination letter request with respect to the qualified status of a new retirement plan that the employer maintains and with respect to which the employer has not previously made a determination letter request. An employer is eligible under the provision if (1) the employer has no more than 100 employees, (2) the employer has at least one nonhighly compensated employee who is participating in the plan, and (3) during the three-taxable year period immediately preceding the taxable year in which the request is made, neither the employer nor a related employer established or maintained a qualified plan with respect to which contributions were made or benefits were accrued for substantially the same employees covered under the plan with respect to which the request is made. In addition, determination letter requests for which user fees are not required under the provision are not taken into account in determining average user fees. The provision applies only to requests by employers for determination letters concerning the qualified retirement plans they maintain. Therefore, a sponsor of a prototype plan is required to pay a user fee for a request for a notification letter, opinion letter, or similar ruling. An employer that adopts a prototype plan, however, is not required to pay a user fee for a determination letter request with respect to the employer's plan.

EFFECTIVE DATE

The provision is effective for determination letter requests made after December 31, 2001.

(l) Treatment of nonresident aliens engaged in international transportation services (Sec. 622 of the bill and Sec. 861(a)(3) of the Code)

PRESENT LAW

Generally, compensation for services performed in the United States is treated as U.S. source income. Under a special rule, compensation is not treated as U.S. source income if the compensation is paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States. However, this special rule does not apply for purposes of qualified retirement plans (including the minimum coverage and nondiscrimination requirements applicable to such plans), employer-provided group-term life insurance, or employer-provided accident and health plans.

REASONS FOR CHANGE

The Committee believes that nonresident aliens who are in the United States temporarily as crew members of foreign vessels engaged in transportation between the United States and a foreign country or a possession of the United States and who otherwise have no U.S. source income for Federal tax purposes should be disregarded in applying the nondiscrimination and other requirements applicable to employee benefit plans.

EXPLANATION OF PROVISION

Under the provision, the special rule relating to compensation paid for labor or services performed by a nonresident alien in connection with the individual's temporary presence in the United States as a regular member of the crew of a foreign vessel engaged in transportation between the United States and a foreign country or a possession of the United States compensation is extended in order to apply for purposes of qualified retirement plans, employer-provided group-term life insurance, and employer-provided accident and health plans. Therefore, such compensation is not treated as U.S. source income for any purpose under such plans, including the application of the qualified retirement plan minimum coverage and nondiscrimination requirements.

EFFECTIVE DATE

The provision is effective with respect to remuneration for services performed in plan years beginning after December 31, 2001.

2. Enhancing fairness for women

(a) Additional salary reduction catch-up contributions (Sec. 631 of the bill and Sec. 414 of the Code)

PRESENT LAW

Elective deferral limitations

Under present law, under certain salary reduction arrangements, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals.

The maximum annual amount of elective deferrals that an individual may make to a qualified cash or deferred arrangement (a "401(k) plan"), a tax-sheltered annuity ("section 403(b) annuity") or a salary reduction simplified employee pension plan ("SEP") is $10,500 (for 2001). The maximum annual amount of elective deferrals that an individual may make to a SIMPLE plan is $6,500 (for 2001). These limits are adjusted annually for inflation for inflation in $500 increments.

Section 457 plans

The maximum annual deferral under a deferred compensation plan of a State or local government or a tax-exempt organization (a "section 457 plan") is the lesser of (1) $8,500 (for 2001) or (2) 33⅓ percent of compensation. The $8,500 dollar limit is increased for inflation in $500 increments. Under a special catch-up rule, the section 457 plan may provide that, for one or more of the participant's last three years before retirement, the otherwise applicable limit is increased to the lesser of (1) $15,000 or (2) the sum of the otherwise applicable limit for the year plus the amount by which the limit applicable in preceding years of participation exceeded the deferrals for that year.

REASONS FOR CHANGE

Although the Committee believes that individuals should be saving for retirement throughout their working lives, as a practical matter, many individuals simply do not focus on the amount of retirement savings they need until they near retirement. In addition, many individuals may have difficulty saving more in earlier years, e.g., because an employee leaves the workplace to care for a family. Some individuals may have a greater ability to save as they near retirement.

The Committee believes that the pension laws should assist individuals who are nearing retirement to save more for their retirement.

EXPLANATION OF PROVISION

The bill provides that the otherwise applicable dollar limit on elective deferrals under a section 401(k) plan, section 403(b) annuity, SEP, or SIMPLE, or deferrals under a section 457 plan is increased for individuals who have attained age 50 by the end of the year.[73] Additional contributions could be made by an individual who has attained age 50 before the end of the plan year and with respect to whom no other elective deferrals may otherwise be made to the plan for the year because of the application of any limitation of the Code (e.g., the annual limit on elective deferrals) or of the plan. Under the provision, the additional amount of elective contributions that could be made by an eligible individual participating in such a plan is the lesser of (1) the applicable dollar amount or (2) the participant's compensation for the year reduced by any other elective deferrals of the participant for the year.[74] The applicable dollar amount is $500 for 2002 through 2004, $1,000 for 2005 and 2006, $2,000 for 2007, $3,000 for 2008, $4,000 for 2009, and $7,500 for 2010 and thereafter.

Catch-up contributions made under the provision are not subject to any other contribution limits and are not taken into account in applying other contribution limits. In addition, such contributions are not subject to applicable nondiscrimination rules.[75]

An employer is permitted to make matching contributions with respect to catch-up contributions. Any such matching contributions are subject to the normally applicable rules.

The following examples illustrate the application of the provision, after the catch-up is fully phased-in.

[73] Another provision increases the dollar limit on elective deferrals under such arrangements.

[74] In the case of a section 457 plan, this catch-up rule does not apply during the participant's last three years before retirement (in those years, the regularly applicable dollar limit is doubled).

[75] Another provision increases the dollar limit on elective deferrals under such arrangements.

Example 1: Employee A is a highly compensated employee who is over 50 and who participates in a section 401(k) plan sponsored by A's employer. The maximum annual deferral limit (without regard to the provision) is $15,000. After application of the special nondiscrimination rules applicable to section 401(k) plans, the maximum elective deferral A may make for the year is $8,000. Under the provision, A is able to make additional catch-up salary reduction contributions of $7,500.

Example 2: Employee B, who is over 50, is a participant in a section 401(k) plan. B's compensation for the year is $30,000. The maximum annual deferral limit (without regard to the provision) is $15,000. Under the terms of the plan, the maximum permitted deferral is 10 percent of compensation or, in B's case, $3,000. Under the provision, B can contribute up to $10,500 for the year ($3,000 under the normal operation of the plan, and an additional $7,500 under the provision).

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

(b) Equitable treatment for contributions of employees to defined contribution plans (Sec. 632 of the bill and Secs. 403(b), 415, and 457 of the Code)

PRESENT LAW

Present law imposes limits on the contributions that may be made to tax-favored retirement plans.

Defined contribution plans

In the case of a tax-qualified defined contribution plan, the limit on annual additions that can be made to the plan on behalf of an employee is the lesser of $35,000 (for 2001) or 25 percent of the employee's compensation (Sec. 415(c)). Annual additions include employer contributions, including contributions made at the election of the employee (i.e., employee elective deferrals), after-tax employee contributions, and any forfeitures allocated to the employee. For this purpose, compensation means taxable compensation of the employee, plus elective deferrals, and similar salary reduction contributions. A separate limit applies to benefits under a defined benefit plan.

For years before January 1, 2000, an overall limit applied if an employee was a participant in both a defined contribution plan and a defined benefit plan of the same employer.

Tax-sheltered annuities

In the case of a tax-sheltered annuity (a "section 403(b) annuity"), the annual contribution generally cannot exceed the lesser of the exclusion allowance or the section 415(c) defined contribution limit. The exclusion allowance for a year is equal to 20 percent of the employee's includible compensation, multiplied by the employee's years of service, minus excludable contributions for prior years under qualified plans, tax-sheltered annuities or section 457 plans of the employer.

In addition to this general rule, employees of nonprofit educational institutions, hospitals, home health service agencies, health and welfare service agencies, and churches may elect application of one of several special rules that increase the amount of the otherwise permitted contributions. The election of a special rule is irrevocable; an employee may not elect to have more than one special rule apply.

Under one special rule, in the year the employee separates from service, the employee may elect to contribute up to the exclusion allowance, without regard to the 25 percent of compensation limit under section 415. Under this rule, the exclusion allowance is determined by taking into account no more than 10 years of service.

Under a second special rule, the employee may contribute up to the lesser of: (1) the exclusion allowance; (2) 25 percent of the participant's includible compensation; or (3) $15,000.

Under a third special rule, the employee may elect to contribute up to the section 415(c) limit, without regard to the exclusion allowance. If this option is elected, then contributions to other plans of the employer are also taken into account in applying the limit.

For purposes of determining the contribution limits applicable to section 403(b) annuities, includible compensation means the amount of compensation received from the employer for the most recent period which may be counted as a year of service under the exclusion allowance. In addition, includible compensation includes elective deferrals and similar salary reduction amounts.

Treasury regulations include provisions regarding application of the exclusion allowance in cases where the employee participates in a section 403(b) annuity and a defined benefit plan. The Taxpayer Relief Act of 1997 directed the Secretary of the Treasury to revise these regulations, effective for years beginning after December 31, 1999, to reflect the repeal of the overall limit on contributions and benefits.

Section 457 plans

Compensation deferred under an eligible deferred compensation plan of a tax-exempt or State and local governmental employer (a "section 457 plan") is not includible in gross income until paid or made available. In general, the maximum permitted annual deferral under such a plan is the lesser of (1) $8,500 (in 2001) or (2) 33⅓ percent of compensation. The $8,500 limit is increased for inflation in $500 increments.

REASONS FOR CHANGE

The present-law rules that limit contributions to defined contribution plans by a percentage of compensation reduce the amount that lower- and middle-income workers can save for retirement. The present-law limits may not allow such workers to accumulate adequate retirement benefits, particularly if a defined contribution plan is the only type of retirement plan maintained by the employer.

Conforming the contribution limits for tax-sheltered annuities to the limits applicable to retirement plans will simplify the administration of the pension laws, and provide more equitable treatment for participants in similar types of plans.

EXPLANATION OF PROVISION

Increase in defined contribution plan limit

The provision increases the 25 percent of compensation limitation on annual additions under a defined contribution plan to 50 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.[76]

Conforming limits on tax-sheltered annuities

The provision repeals the exclusion allowance applicable to contributions to tax-sheltered annuities. Thus, such annuities are subject to the limits applicable to tax-qualified plans.

The provision also directs the Secretary of the Treasury to revise the regulations relating to the exclusion allowance under section 403(b)(2) to render void the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance. For taxable years beginning after December 31, 2000, the regulatory provisions regarding the exclusion allowance are applied as if the requirement that contributions to a defined benefit plan be treated as previously excluded amounts for purposes of the exclusion allowance were void.

Section 457 plans

The provision increases the 33⅓ percent of compensation limitation on deferrals under a section 457 plan to 50 percent for 2002 through 2010, and 100 percent for 2011 and thereafter.

EFFECTIVE DATE

The provision generally is effective for years beginning after December 31, 2001. The provision regarding the regulations under section 403(b)(2) is effective on the date of enactment. The provision regarding the repeal of the exclusion allowance applicable to tax-sheltered annuities is effective for years beginning after December 31, 2010.

(c) Faster vesting of employer matching contributions (Sec. 633 of the bill and Sec. 411 of the Code)

PRESENT LAW

Under present law, 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.[77]

[76] Another provision increases the defined contribution plan dollar limit.
[77] The minimum vesting requirements are also contained in Title I of ERISA.

REASONS FOR CHANGE

The Committee understands that many employees, particularly lower- and middle-income employees, do not take full advantage of the retirement savings opportunities provided by their employer's section 401(k) plan. The Committee believes that providing faster vesting for matching contributions will make section 401(k) plans more attractive for employees, particularly lower- and middle-income employees, and will encourage employees to save more for their own retirement. In addition, faster vesting for matching contributions will enable short-service employees to accumulate greater retirement savings.

EXPLANATION OF PROVISION

The provision applies faster vesting schedules to employer matching contributions. Under the provision, employer matching contributions must 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.

EFFECTIVE DATE

The provision is effective for contributions for plan years beginning after December 31, 2001, with a delayed effective date for plans maintained pursuant to a collective bargaining agreement. 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.

(d) Modifications to minimum distribution rules (Sec. 634 of the bill and Sec. 401(a)(9) of the Code)

PRESENT LAW

In general

Minimum distribution rules apply to all types of tax-favored retirement vehicles, including qualified plans, individual retirement arrangements ("IRAs"), tax-sheltered annuities ("section 403(b) annuities"), and eligible deferred compensation plans of tax-exempt and State and local government employers ("section 457 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 individual plan participant equal to 50 percent of the required minimum distribution not distributed for the year. The excise tax may be waived if the individual establishes to the satisfaction of the Commissioner that the shortfall in the amount distributed was due to reasonable error and reasonable steps are being taken to remedy the shortfall. Under certain circumstances following the death of a participant, the excise tax is automatically waived under proposed Treasury regulations.

Distributions prior to the death of the individual

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, life expectancies of the participant and the participant's spouse may be recomputed annually.

In the case of qualified plans, tax-sheltered annuities, and section 457 plans, the required beginning date is the April 1 of the calendar year following the later of (1) the calendar year in which the employee attains age 70½ or (2) the calendar year in which the employee retires. However, in the case of a 5-percent owner of the employer, distributions are required to begin no later than the April 1 of the calendar year following the year in which the 5-percent owner attains age 70½. If commencement of benefits is delayed beyond age 70½ from a defined benefit plan, then the accrued benefit of the employee must be actuarially increased to take into account the period after age 70½ in which the employee was not receiving benefits under the plan.[78] In the case of distributions from an IRA other than a Roth IRA, the required beginning date is the April 1 following the calendar year in which the IRA owner attains age 70½. The pre-death minimum distribution rules do not apply to Roth IRAs.

In general, under proposed Treasury regulations, in order to satisfy the minimum distribution rules, annuity payments under a defined benefit plan must be paid in periodic payments made at intervals not longer than one year over a permissible period, and must be nonincreasing, or increase only as a result of the following: (1) cost-of-living adjustments; (2) cash refunds of employee contributions; (3) benefit increases under the plan; or (4) an adjustment due to death of the employee's beneficiary. In the case of a defined contribution plan, the minimum required distribution is determined by dividing the employee's benefit by an amount from the uniform table provided in the proposed regulations.

Distributions after the death of the plan participant

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 inter-

[78] State and local government plans and church plans are not required to actuarially increase benefits that begin after age 70½.

est 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 distribution until the date the deceased participant would have attained age 70½.

Special rules for section 457 plans

Eligible deferred compensation plans of State and local and tax-exempt employers ("section 457 plans") are subject to the minimum distribution rules described above. Such plans are also subject to additional minimum distribution requirements (Sec. 457(d)(2)(b)).

REASONS FOR CHANGE

For many years, the minimum distribution rules have been among the most complex of the rules relating to tax-favored arrangements. On January 17, 2001, the Secretary of the Treasury issued revised proposed regulations relating to the minimum distribution rules. The Committee believes that the implementation of these revised proposed regulations, along with additional statutory modifications of the minimum distribution rules, will result in significant simplification for individuals and plan administrators.

EXPLANATION OF PROVISION

The provision applies the present-law rules applicable if the participant dies before distribution of minimum benefits has begun to all post-death distributions. Thus, in general, if the employee dies before his or her entire interest has been distributed, distribution of the remaining interest is required to be made within five years of the date of death, or begin within one year of the date of death and paid over the life or life expectancy of a designated beneficiary. In the case of a surviving spouse, distributions are not required to begin until the surviving spouse attains age 70½. The provision includes a transition rule with respect to the provision providing that the required beginning date in the case of a surviving spouse is no earlier than the April 1 of the calendar year following the calendar year in which the surviving spouse attains age 70½. In the case of an individual who died before the date of enactment and prior to his or her required beginning date and whose beneficiary is the surviving spouse, minimum distributions to the surviving spouse are not required to begin earlier than the date distributions would have been required to begin under present law.

In addition, the Treasury is directed to revise the life expectancy tables under the applicable regulations to reflect current life expectancy.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(e) Clarification of tax treatment of division of section 457 plan benefits upon divorce (Sec. 635 of the bill and Secs. 414(p) and 457 of the Code)

PRESENT LAW

Under 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. One exception to the prohibition on assignment or alienation rule is a qualified domestic relations order ("QDRO"). A QDRO is a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant, and that meets certain procedural requirements.

Under present law, a distribution from a governmental plan or a church plan is treated as made pursuant to a QDRO if it is made pursuant to a domestic relations order that creates or recognizes a right of an alternate payee to any plan benefit payable with respect to a participant. Such distributions are not required to meet the procedural requirements that apply with respect to distributions from qualified plans.

Under present law, amounts distributed from a qualified plan generally are taxable to the participant in the year of distribution. However, if amounts are distributed to the spouse (or former spouse) of the participant by reason of a QDRO, the benefits are taxable to the spouse (or former spouse). Amounts distributed pursuant to a QDRO to an alternate payee other than the spouse (or former spouse) are taxable to the plan participant.

Section 457 of the Internal Revenue Code provides rules for deferral of compensation by an individual participating in an eligible deferred compensation plan ("section 457 plan") of a tax-exempt or State and local government employer. The QDRO rules do not apply to section 457 plans.

REASONS FOR CHANGE

The Committee believes that the rules regarding qualified domestic relations orders should apply to all types of employer-sponsored retirement plans.

EXPLANATION OF PROVISION

The provision applies the taxation rules for qualified plan distributions pursuant to a QDRO to distributions made pursuant to a domestic relations order from a section 457 plan. In addition, a section 457 plan is not treated as violating the restrictions on distributions from such plans due to payments to an alternate payee under a QDRO. The special rule applicable to governmental plans and church plans applies for purposes of determining whether a distribution is pursuant to a QDRO.

EFFECTIVE DATE

The provision relating to tax treatment of distributions made pursuant to a domestic relations order from a section 457 plan is effective for transfers, distributions, and payments made after December 31, 2001. The provisions relating to the waiver of restrictions on distributions and the application of the special rule for determining whether a distribution is pursuant to a QDRO is effective on January 1, 2002, except that in the case of a domestic relations order entered before January 1, 2002, the plan administrator (1) is required to treat such order as a QDRO if the administrator is paying benefits pursuant to such order on January 1, 2002, and (2) is permitted to treat any other such order entered before January 1, 2002, as a QDRO even if such order does not meet the relevant requirements of the provision.

(f) Provisions relating to hardship withdrawals (Sec. 636 of the bill and Secs. 401(k) and 402 of the Code)

PRESENT LAW

Elective deferrals under a qualified cash or deferred arrangement (a "section 401(k) plan") may not be distributable prior to the occurrence of one or more specified events. One event upon which distribution is permitted is the financial hardship of the employee. Applicable Treasury regulations[79] provide that a distribution is made on account of hardship only if the distribution is made on account of an immediate and heavy financial need of the employee and is necessary to satisfy the heavy need.

The Treasury regulations provide a safe harbor under which a distribution may be deemed necessary to satisfy an immediate and heavy financial need. One requirement of this safe harbor is that the employee be prohibited from making elective contributions and employee contributions to the plan and all other plans maintained by the employer for at least 12 months after receipt of the hardship distribution.

Under present law, hardship withdrawals of elective deferrals from a qualified cash or deferred arrangement (or 403(b) annuity) are not eligible rollover distributions. Other types of hardship distributions, e.g., employer matching contributions distributed on account of hardship, are eligible rollover distributions. Different withholding rules apply to distributions that are eligible rollover distributions and to distributions that are not eligible rollover distributions. Eligible rollover distributions that are not directly rolled over are subject to withholding at a flat rate of 20-percent. Distributions that are not eligible rollover distributions are subject to elective withholding. Periodic distributions are subject to withholding as if the distribution were wages; nonperiodic distributions are subject to withholding at a rate of 10 percent. In either case, the individual may elect not to have withholding apply.

REASONS FOR CHANGE

Although the Committee believes that it is appropriate to restrict the circumstances in which an in-service distribution from a 401(k) plan is permitted and to encourage participants to take such distributions only when necessary to satisfy an immediate and heavy financial need, the Committee is concerned about the impact that a 12–month suspension of contributions may have on the retirement savings of a participant who experiences a hardship. The

[79] Treas. Reg. sec. 1.401(k)–1.

Committee believes that the combination of a six-month contribution suspension and the other elements of the regulatory safe harbor will provide an adequate incentive for a participant to seek sources of funds other than his or her 401(k) plan account balance in order to satisfy financial hardships.

The present-law rules regarding the ability to rollover hardship distributions create administrative burdens for plan administrators and confusion on the part of plan participants. The Committee believes that providing a uniform rule for all hardship distributions will simplify application of the rollover rules.

EXPLANATION OF PROVISION

The Secretary of the Treasury is directed to revise the applicable regulations to reduce from 12 months to six months the period during which an employee must be prohibited from making elective contributions and employee contributions in order for a distribution to be deemed necessary to satisfy an immediate and heavy financial need. The revised regulations are effective for years beginning after December 31, 2001.

In addition, any distribution made upon hardship of an employee is not an eligible rollover distribution. Thus, such distributions are not permitted to be rolled over, and are subject to the withholding rules applicable to distributions that are not eligible rollover distributions. The provision does not modify the rules under which hardship distributions may be made. For example, as under present law, hardship distributions of qualified employer matching contributions are only permitted under the rules applicable to elective deferrals.

The provision is intended to clarify that all assets distributed as a hardship withdrawal, including assets attributable to employee elective deferrals and those attributable to employer matching or nonelective contributions, are ineligible for rollover. This rule is intended to apply to all hardship distributions from any tax qualified plan, including those made pursuant to standards set forth in section 401(k)(2)(B)(i)(IV) (which are applicable to section 401(k) plans and section 403(b) annuities) and to those treated as hardship distributions under any profit-sharing plan (whether or not in accordance with the standards set forth in section 401(k)(2)(B)(i)(IV)). For this purpose, a distribution that could be made either under the hardship provisions of a plan or under other provisions of the plan (such as provisions permitting in-service withdrawal of assets attributable to employer matching or nonelective contributions after a fixed period of years) could be treated as made upon hardship of the employee if the plan treats it that way. For example, if a plan makes an in-service distribution that consists of assets attributable to both elective deferrals (in circumstances where those assets could be distributed only upon hardship) and employer matching or nonelective contributions (which could be distributed in nonhardship circumstances under the plan), the plan is permitted to treat the distribution in its entirety as made upon hardship of the employee.

EFFECTIVE DATE

The provision directing the Secretary to revise the rules relating to safe harbor hardship distributions is effective on the date of enactment. The provision providing that hardship distributions are not eligible rollover distributions is effective distributions made after December 31, 2001. The Secretary is authorized to issue transitional guidance with respect to the provision of the bill providing that hardship distributions are not eligible rollover distributions to provide sufficient time for plans to implement the new rule.

(g) Pension coverage for domestic and similar workers (Sec. 637 of the bill and Sec. 4972(c)(6) of the Code)

PRESENT LAW

Under present law, within limits, employers may make deductible contributions to qualified retirement plans for employees. Subject to certain exception, a 10-percent excise tax applies to nondeductible contributions to such plans.

Employers of household workers may establish a pension plan for their employees. Contributions to such plans are not deductible because they are not made in connection with a trade or business of the employer.

REASONS FOR CHANGE

Under present law, individuals who employ domestic and similar workers may be discouraged from providing pension plan coverage for such employees because of the possible adverse tax consequences from making nondeductible contributions. As a result, such workers, who are typically lower income, may be denied the opportunity for tax-favored retirement savings. The Committee believes that such individuals who employ such workers should be encouraged to provide pension coverage.

EXPLANATION OF PROVISION

Under the provision, the 10-percent excise tax on nondeductible contributions does not apply to contributions to a SIMPLE plan or a SIMPLE individual retirement account, which are nondeductible solely because the contributions are not a trade or business expense under section 162. Thus, for example, employers of household workers are able to make contributions to such plans without imposition of the excise tax. As under present law, the contributions are not deductible. The present-law rules applicable to such plans, e.g., contribution limits and nondiscrimination rules, continue to apply. The provision does not apply with respect to contributions on behalf of the individual and members of his or her family.

No inference is intended with respect to the application of the excise tax under present law to contributions that are not deductible because they are not made in connection with a trade or business of the employer.

As under present law, a plan covering domestic workers is not qualified unless the coverage rules are satisfied by aggregating all employees of family members taken into account under the attribution rules in section 414(c), but disregarding employees employed by a controlled group of corporations or a trade or business.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

3. Increasing portability for participants

(a) Rollovers of retirement plan and IRA distributions (Secs. 641–643 and 649 of the bill and Secs. 401, 402, 403(b), 408, 457, and 3405 of the Code)

PRESENT LAW

In general

Present law permits the rollover of funds from a tax-favored retirement plan to another tax-favored retirement plan. The rules that apply depend on the type of plan involved. Similarly, the rules regarding the tax treatment of amounts that are not rolled over depend on the type of plan involved.

Distributions from qualified plans

Under present law, an "eligible rollover distribution" from a tax-qualified employer-sponsored retirement plan may be rolled over tax free to a traditional individual retirement arrangement ("IRA")[80] or another qualified plan.[81] An "eligible rollover distribution" means any distribution to an employee of all or any portion of the balance to the credit of the employee in a qualified plan, except the term does not include (1) any distribution which is one of a series of substantially equal periodic payments made (a) for the life (or life expectancy) of the employee or the joint lives (or joint life expectancies) of the employee and the employee's designated beneficiary, or (b) for a specified period of 10 years or more, (2) any distribution to the extent such distribution is required under the minimum distribution rules, and (3) certain hardship distributions. The maximum amount that can be rolled over is the amount of the distribution includible in income, i.e., after-tax employee contributions cannot be rolled over. Qualified plans are not required to accept rollovers.

Distributions from tax-sheltered annuities

Eligible rollover distributions from a tax-sheltered annuity ("section 403(b) annuity") may be rolled over into an IRA or another section 403(b) annuity. Distributions from a section 403(b) annuity cannot be rolled over into a tax-qualified plan. Section 403(b) annuities are not required to accept rollovers.

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[80] A "traditional" IRA refers to IRAs other than Roth IRAs or SIMPLE IRAs. All references to IRAs refer only to traditional IRAs.

[81] An eligible rollover distribution may either be rolled over by the distributee within 60 days of the date of the distribution or, as described below, directly rolled over by the distributing plan.

IRA distributions

Distributions from a traditional IRA, other than minimum required distributions, can be rolled over into another IRA. In general, distributions from an IRA cannot be rolled over into a qualified plan or section 403(b) annuity. An exception to this rule applies in the case of so-called "conduit IRAs." Under the conduit IRA rule, amounts can be rolled from a qualified plan into an IRA and then subsequently rolled back to another qualified plan if the amounts in the IRA are attributable solely to rollovers from a qualified plan. Similarly, an amount may be rolled over from a section 403(b) annuity to an IRA and subsequently rolled back into a section 403(b) annuity if the amounts in the IRA are attributable solely to rollovers from a section 403(b) annuity.

Distributions from section 457 plans

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. For example, governmental section 457 plans are like qualified plans in that plan assets are required to be held in a trust for the exclusive benefit of plan participants and beneficiaries. In contrast, benefits under a section 457 plan of a tax-exempt employer are unfunded, like nonqualified deferred compensation plans of private employers.

Section 457 benefits can be transferred to another section 457 plan. Distributions from a section 457 plan cannot be rolled over to another section 457 plan, a qualified plan, a section 403(b) annuity, or an IRA.

Rollovers by surviving spouses

A surviving spouse that receives an eligible rollover distribution may roll over the distribution into an IRA, but not a qualified plan or section 403(b) annuity.

Direct rollovers and withholding requirements

Qualified plans and section 403(b) annuities are required to provide that a plan participant has the right to elect that an eligible rollover distribution be directly rolled over to another eligible retirement plan. If the plan participant does not elect the direct rollover option, then withholding is required on the distribution at a 20-percent rate.

Notice of eligible rollover distribution

The plan administrator of a qualified plan or a section 403(b) annuity is required to provide a written explanation of rollover rules to individuals who receive a distribution eligible for rollover. In general, the notice is to be provided within a reasonable period of time before making the distribution and is to include an explanation of (1) the provisions under which the individual may have the distribution directly rolled over to another eligible retirement plan, (2) the provision that requires withholding if the distribution is not directly rolled over, (3) the provision under which the distribution may be rolled over within 60 days of receipt, and (4) if applicable, certain other rules that may apply to the distribution. The Treasury Department has provided more specific guidance regarding timing and content of the notice.

Taxation of distributions

As is the case with the rollover rules, different rules regarding taxation of benefits apply to different types of tax-favored arrangements. In general, distributions from a qualified plan, section 403(b) annuity, or IRA are includible in income in the year received. In certain cases, distributions from qualified plans are eligible for capital gains treatment and averaging. These rules do not apply to distributions from another type of plan. Distributions from a qualified plan, IRA, and section 403(b) annuity generally are subject to an additional 10-percent early withdrawal tax if made before age 59½. There are a number of exceptions to the early withdrawal tax. Some of the exceptions apply to all three types of plans, and others apply only to certain types of plans. For example, the 10-percent early withdrawal tax does not apply to IRA distributions for educational expenses, but does apply to similar distributions from qualified plans and section 403(b) annuities. Benefits under a section 457 plan are generally includible in income when paid or made available. The 10-percent early withdrawal tax does not apply to section 457 plans.

REASONS FOR CHANGE

Present law encourages individuals who receive distributions from qualified plans and similar arrangements to save those distributions for retirement by facilitating tax-free rollovers to an IRA or another qualified plan. The Committee believes that expanding the rollover options for individuals in employer-sponsored retirement plans and owners of IRAs will provide further incentives for individuals to continue to accumulate funds for retirement. The Committee believes it appropriate to extend the same rollover rules to governmental section 457 plans; like qualified plans, such plans are required to hold plan assets in trust for employees.

EXPLANATION OF PROVISION

In general

The bill provides that eligible rollover distributions from qualified retirement plans, section 403(b) annuities, and governmental section 457 plans generally may be rolled over to any of such plans or arrangements.[82] Similarly, distributions from an IRA generally are permitted to be rolled over into a qualified plan, section 403(b) annuity, or governmental section 457 plan. The direct rollover and withholding rules are extended to distributions from a governmental section 457 plan, and such plans are required to provide the written notification regarding eligible rollover distributions. The rollover notice (with respect to all plans) is required to include a description of the provisions under which distributions from the plan to which the distribution is rolled over may be subject to restrictions and tax consequences different than those applicable to

[82] Hardship distributions from governmental section 457 plans are considered eligible rollover distributions.

distributions from the distributing plan. Qualified plans, section 403(b) annuities, and section 457 plans are not required to accept rollovers.

Some special rules apply in certain cases. A distribution from a qualified plan is not eligible for capital gains or averaging treatment if there was a rollover to the plan that would not have been permitted under present law. Thus, in order to preserve capital gains and averaging treatment for a qualified plan distribution that is rolled over, the rollover must be made to a "conduit IRA" as under present law, and then rolled back into a qualified plan. Amounts distributed from a section 457 plan are subject to the early withdrawal tax to the extent the distribution consists of amounts attributable to rollovers from another type of plan. Section 457 plans are required to separately account for such amounts.

Rollover of after-tax contributions

The bill provides that employee after-tax contributions may be rolled over into another qualified plan or a traditional IRA. In the case of a rollover from a qualified plan to another qualified plan, the rollover is permitted to be accomplished only through a direct rollover. In addition, a qualified plan is not permitted to accept rollovers of after-tax contributions unless the plan provides separate accounting for such contributions (and earnings thereon). After-tax contributions (including nondeductible contributions to an IRA) are not permitted to be rolled over from an IRA into a qualified plan, tax-sheltered annuity, or section 457 plan.

In the case of a distribution from a traditional IRA that is rolled over into an eligible rollover plan that is not an IRA, the distribution is attributed first to amounts other than after-tax contributions.

Expansion of spousal rollovers

The bill provides that surviving spouses may roll over distributions to a qualified plan, section 403(b) annuity, or governmental section 457 plan in which the spouse participates.

Treasury regulations

The Secretary is directed to prescribe rules necessary to carry out the provisions. Such rules may include, for example, reporting requirements and mechanisms to address mistakes relating to rollovers. It is anticipated that the IRS will develop forms to assist individuals who roll over after-tax contributions to an IRA in keeping track of such contributions. Such forms could, for example, expand Form 8606—Nondeductible IRAs, to include information regarding after-tax contributions.

EFFECTIVE DATE

The provision is effective for distributions made after December 31, 2001.

(b) Waiver of 60-day rule (sec. 644 of the bill and Secs. 402 and 408 of the Code)

PRESENT LAW

Under present law, amounts received from an IRA or qualified plan may be rolled over tax free if the rollover is made within 60 days of the date of the distribution. The Secretary does not have the authority to waive the 60-day requirement, except during military service in a combat zone or by reason of a Presidentially declared disaster. The Secretary has issued regulations postponing the 60-day rule in such cases.

REASONS FOR CHANGE

The inability of the Secretary to waive the 60-day rollover period may result in adverse tax consequences for individuals. The Committee believes such harsh results are inappropriate and that providing for waivers of the rule will help facilitate rollovers.

EXPLANATION OF PROVISION

The bill provides that the Secretary may waive the 60-day rollover period if the failure to waive such requirement would be against equity or good conscience, including cases of casualty, disaster, or other events beyond the reasonable control of the individual subject to such requirement. For example, the Secretary may issue guidance that includes objective standards for a waiver of the 60-day rollover period, such as waiving the rule due to military service in a combat zone or during a Presidentially declared disaster (both of which are provided for under present law), or for a period during which the participant has received payment in the form of a check, but has not cashed the check, or for errors committed by a financial institution.

EFFECTIVE DATE

The provision applies to distributions made after December 31, 2001.

(c) Treatment of forms of distribution (Sec. 645 of the bill and Sec. 411(d)(6) of the Code)

PRESENT LAW

An amendment of a qualified retirement plan may not decrease the accrued benefit of a plan participant. An amendment is 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 (Sec. 411(d)(6)).[83]

Under regulations recently issued by the Secretary,[84] this prohibition against the elimination of an optional form of benefit does not apply in the case of (1) a defined contribution plan that offers a lump sum at the same time as the form being eliminated if the

[83] A similar provision is contained in Title I of ERISA.
[84] Treas. Reg. sec. 1.411(d)-4, Q&A–2(e) and Q&A–(3)(b).

participant receives at least 90 days' advance notice of the elimination, or (2) a voluntary transfer between defined contribution plans, subject to the requirements that a transfer from a money purchase pension plan, an ESOP, or a section 401(k) plan must be to a plan of the same type and that the transfer be made in connection with certain corporate mergers, acquisitions, or similar transactions or changes in employment status.

Reasons for Change

The Committee understands that the application of the prohibition against the elimination of any optional form of benefit frequently results in complexity and confusion, especially in the context of business acquisitions and similar transactions, and makes it difficult for participants to understand their benefit options and make choices that are best-suited to their needs. The Committee believes that it is appropriate to permit the elimination of duplicative benefit options that develop following plan mergers and similar events while ensuring that meaningful early retirement benefit payment options and subsidies may not be eliminated.

Explanation of Provision

A defined contribution plan to which benefits are transferred is not treated as reducing a participant's or beneficiary's accrued benefit even though it does not provide all of the forms of distribution previously available under the transferor plan if (1) the plan receives from another defined contribution plan a direct transfer of the participant's or beneficiary's benefit accrued under the transferor plan, or the plan results from a merger or other transaction that has the effect of a direct transfer (including consolidations of benefits attributable to different employers within a multiple employer plan), (2) the terms of both the transferor plan and the transferee plan authorize the transfer, (3) the transfer occurs pursuant to a voluntary election by the participant or beneficiary that is made after the participant or beneficiary received a notice describing the consequences of making the election, and (4) the transferee plan allows the participant or beneficiary to receive distribution of his or her benefit under the transferee plan in the form of a single sum distribution.

Furthermore, the provision directs the Secretary of the Treasury to provide by regulations that the prohibitions against eliminating or reducing an early retirement benefit, a retirement-type subsidy, or an optional form of benefit do not apply to plan amendments that eliminate or reduce early retirement benefits, retirement-type subsidies, and optional forms of benefit that create significant burdens and complexities for a plan and its participants, but only if such an amendment does not adversely affect the rights of any participant in more than a de minimis manner.

It is intended that the factors to be considered in determining whether an amendment has more than a de minimis adverse effect on any participant will include (1) all of the participant's early retirement benefits, retirement-type subsidies, and optional forms of benefits that are reduced or eliminated by the amendment, (2) the extent to which early retirement benefits, retirement-type subsidies, and optional forms of benefit in effect with respect to a participant after the amendment effective date provide rights that are comparable to the rights that are reduced or eliminated by the plan amendment, (3) the number of years before the participant attains normal retirement age under the plan (or early retirement age, as applicable), (4) the size of the participant's benefit that is affected by the plan amendment, in relation to the amount of the participant's compensation, and (5) the number of years before the plan amendment is effective.

The Secretary is directed to issue, not later than December 31, 2002, final regulations under section 411(d)(6), including regulations required under the provision.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001, except that the direction to the Secretary is effective on the date of enactment.

(d) Rationalization of restrictions on distributions (Sec. 646 of the bill and Secs. 401(k), 403(b), and 457 of the Code)

PRESENT LAW

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan"), tax-sheltered annuity ("section 403(b) annuity"), or an eligible deferred compensation plan of a tax-exempt organization or State or local government ("section 457 plan"), may not be distributable prior to the occurrence of one or more specified events. These permissible distributable events include "separation from service."

A separation from service occurs only upon a participant's death, retirement, resignation or discharge, and not when the employee continues on the same job for a different employer as a result of the liquidation, merger, consolidation or other similar corporate transaction. A severance from employment occurs when a participant ceases to be employed by the employer that maintains the plan. Under a so-called "same desk rule," a participant's severance from employment does not necessarily result in a separation from service.

In addition to separation from service and other events, a section 401(k) plan that is maintained by a corporation may permit distributions to certain employees who experience a severance from employment with the corporation that maintains the plan but do not experience a separation from service because the employees continue on the same job for a different employer as a result of a corporate transaction. If the corporation disposes of substantially all of the assets used by the corporation in a trade or business, a distributable event occurs with respect to the accounts of the employees who continue employment with the corporation that acquires the assets. If the corporation disposes of its interest in a subsidiary, a distributable event occurs with respect to the accounts of the employees who continue employment with the subsidiary. Under a recent IRS ruling, a person is generally deemed to have separated from service if that person is transferred to another employer in connection with a sale of less than substantially all the assets of a trade or business.[85]

REASONS FOR CHANGE

The Committee believes that application of the “same desk” rule is inappropriate because it hinders portability of retirement benefits, creates confusion for employees, and results in significant administrative burdens for employers that engage in business acquisition transactions.

EXPLANATION OF PROVISION

The provision modifies the distribution restrictions applicable to section 401(k) plans, section 403(b) annuities, and section 457 plans to provide that distribution may occur upon severance from employment rather than separation from service. In addition, the provisions for distribution from a section 401(k) plan based upon a corporation’s disposition of its assets or a subsidiary are repealed; this special rule is no longer necessary under the provision.

EFFECTIVE DATE

The provision is effective for distributions after December 31, 2001, regardless of when the severance of employment occurred.

(e) Purchase of service credit under governmental pension plans (Sec. 647 of the bill and Secs. 403(b) and 457 of the Code)

PRESENT LAW

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 (Sec. 415). Permissive service credit means credit for a period of service recognized by the governmental plan 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.

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.

A participant may not use a rollover or direct transfer of benefits from a tax-sheltered annuity (“section 403(b) annuity”) or an eligible deferred compensation plan of a tax-exempt organization of a State or local government (“section 457 plan”) to purchase permis-

[85] Rev. Rul. 2000–27, 2000–21 I.R.B. 1016.

sive service credits or repay contributions and earnings with respect to a forfeiture of service credit.

REASONS FOR CHANGE

The Committee understands that many employees work for multiple State or local government employers during their careers. The Committee believes that allowing such employees to use their section 403(b) annuity and section 457 plan accounts to purchase permissive service credits or make repayments with respect to forfeitures of service credit will result in more significant retirement benefits for employees who would not otherwise be able to afford such credits or repayments.

EXPLANATION OF PROVISION

A participant in a State or local governmental plan 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 credits 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).

EFFECTIVE DATE

The provision is effective for transfers after December 31, 2001.

(f) Employers may disregard rollovers for purposes of cash-out rules (Sec. 648 of the bill and Sec. 411(a)(11) of the Code)

PRESENT LAW

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.[86]

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan.[87]

REASONS FOR CHANGE

The present-law cash-out rule reflects a balancing of various policies. On the one hand is the desire to assist individuals to save for retirement by making it easier to keep retirement funds in tax-favored vehicles. On the other hand is the recognition that keeping

[86] A similar provision is contained in Title I of ERISA.
[87] Other provisions expand the kinds of plans to which benefits may be rolled over.

track of small account balances of former employees creates administrative burdens for plans.

The Committee is concerned that, in some cases, the cash-out rule may discourage plans from accepting rollovers because the rollover will increase participants' benefits to above the cash-out amount, and increase administrative burdens. The Committee believes that disregarding rollovers for purposes of the cash-out rule will further the intent of the cash-out rule by removing a possible disincentive for plans to accept rollovers.

EXPLANATION OF PROVISION

A plan is permitted to provide that the present value of a participant's nonforfeitable accrued benefit is determined without regard to the portion of such benefit that is attributable to rollover contributions (and any earnings allocable thereto).

EFFECTIVE DATE

The provision is effective for distributions after December 31, 2001.

(g) Minimum distribution and inclusion requirements for section 457 plans (Sec. 649 of the bill and 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. For example, amounts deferred under a section 457 plan cannot exceed certain limits. Amounts deferred under a section 457 plan are generally includible in income when paid or made available. Amounts deferred under a plan of deferred compensation of a State or local government or tax-exempt employer that does not meet the requirements of section 457 are includible in income when the amounts are not subject to a substantial risk of forfeiture, regardless of whether the amounts have been paid or made available.[88]

Section 457 plans are subject to the minimum distribution rules applicable to tax-qualified pension plans. In addition, such plans are subject to additional minimum distribution rules (Sec. 457(d)(2)(B)).

REASONS FOR CHANGE

The Committee believes that the rules for timing of inclusion of benefits under a governmental section 457 plan should be conformed to the rules relating to qualified plans. The Committee also believes that section 457 plans should be subject to the same minimum distribution rules applicable to qualified plans.

EXPLANATION OF PROVISION

The bill provides that amounts deferred under a section 457 plan of a State or local government are includible in income when paid.

[88] This rule of inclusion does not apply to amounts deferred under a tax-qualified retirement plan or similar plans.

The provision also repeals the special minimum distribution rules applicable to section 457 plans. Thus, such plans are subject to the minimum distribution rules applicable to qualified plans.

EFFECTIVE DATE

The provision is effective for distributions after December 31, 2001.

4. Strengthening pension security and enforcement

(a) Phase-in repeal of 160 percent of current liability funding limit; deduction for contributions to fund termination liability (Secs. 651 and 652 of the bill and Secs. 404(a)(1), 412(c)(7), and 4972(c) of the Code)

PRESENT LAW

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (Sec. 412(c)(7)).[89] In general, current liability is all liabilities to plan participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.[90] In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

REASONS FOR CHANGE

The Committee is concerned that the current liability full funding limit, which focuses on current but not projected benefits, may result in inadequate funding of pension plans and thus jeopardize pension security. The Committee believes that repealing the current liability full funding limit will encourage responsible pension

[89] The minimum funding requirements, including the full funding limit, are also contained in title I of ERISA.

[90] As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text.

funding and help ensure that plan participants receive promised benefits. Also, the Committee believes that the special deduction rule should be expanded to give more plan sponsors incentives to adequately fund their plans.

EXPLANATION OF PROVISION

Current liability full funding limit

The provision gradually increases and then repeals the current liability full funding limit. The current liability full funding limit is 160 percent of current liability for plan years beginning in 2002, 165 percent for plan years beginning in 2003, and 170 percent for plan years beginning in 2004. The current liability full funding limit is repealed for plan years beginning in 2005 and thereafter. Thus, in 2005 and thereafter, the full funding limit is the excess, if any, of (1) the accrued liability under the plan (including normal cost), over (2) the value of the plan's assets.

Deduction for contributions to fund termination liability

The special rule allowing a deduction for unfunded current liability generally is extended to all defined benefit pension plans, i.e., the provision applies to multiemployer plans and plans with 100 or fewer participants. The special rule does not apply to plans not covered by the PBGC termination insurance program.[91]

The provision also modifies the special rule by providing that the deduction is for up to 100 percent of unfunded termination liability, determined as if the plan terminated at the end of the plan year. In the case of a plan with less than 100 participants for the plan year, termination liability does not include the liability attributable to benefit increases for highly compensated employees resulting from a plan amendment which was made or became effective, whichever is later, within the last two years.

EFFECTIVE DATE

The provision is effective for plan years beginning after December 31, 2001.

(b) Excise tax relief for sound pension funding (Sec. 653 of the bill and Sec. 4972 of the Code)

PRESENT LAW

Under present law, defined benefit pension plans are subject to minimum funding requirements designed to ensure that pension plans have sufficient assets to pay benefits. A defined benefit pension plan is funded using one of a number of acceptable actuarial cost methods.

No contribution is required under the minimum funding rules in excess of the full funding limit. The full funding limit is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 160 percent of the plan's current liability, over (2) the value of the plan's assets (Sec. 412(c)(7)). In general, current liability is all liabilities to plan

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

participants and beneficiaries accrued to date, whereas the accrued liability full funding limit is based on projected benefits. The current liability full funding limit is scheduled to increase as follows: 165 percent for plan years beginning in 2003 and 2004, and 170 percent for plan years beginning in 2005 and thereafter.[92] In no event is a plan's full funding limit less than 90 percent of the plan's current liability over the value of the plan's assets.

An employer sponsoring a defined benefit pension plan generally may deduct amounts contributed to satisfy the minimum funding standard for the plan year. Contributions in excess of the full funding limit generally are not deductible. Under a special rule, an employer that sponsors a defined benefit pension plan (other than a multiemployer plan) which has more than 100 participants for the plan year may deduct amounts contributed of up to 100 percent of the plan's unfunded current liability.

Present law also provides that contributions to defined contribution plans are deductible, subject to certain limitations.

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. The 10-percent excise tax does not apply to contributions to certain terminating defined benefit plans. The 10-percent excise tax also does not apply to contributions of up to six percent of compensation to a defined contribution plan for employer matching and employee elective deferrals.

REASONS FOR CHANGE

The Committee believes that employers should be encouraged to adequately fund their pension plans. Therefore, the Committee does not believe that an excise tax should be imposed on employer contributions that do not exceed the accrued liability full funding limit.

EXPLANATION OF PROVISION

In determining the amount of nondeductible contributions, the employer is permitted to elect not to take into account contributions to a defined benefit pension plan except to the extent they exceed the accrued liability full funding limit. Thus, if an employer elects, contributions in excess of the current liability full funding limit are not subject to the excise tax on nondeductible contributions. An employer making such an election for a year is not permitted to take advantage of the present-law exceptions for certain terminating plans and certain contributions to defined contribution plans.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

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[92] As originally enacted in the Pension Protection Act of 1997, the current liability full funding limit was 150 percent of current liability. The Taxpayer Relief Act of 1997 increased the current liability full funding limit to 155 percent in 1999 and 2000, 160 percent in 2001 and 2002, and adopted the scheduled increases described in the text. Another provision gradually increases and then repeals the current liability full funding limit.

(c) Modifications to section 415 limits for multiemployer plans (Sec. 654 of the bill and Sec. 415 of the Code)

PRESENT LAW

Under present law, limits apply to contributions and benefits under qualified plans (Sec. 415). 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) 100 percent of average compensation for the highest three years, or (2) $140,000 (for 2001). The dollar limit is adjusted for cost-of-living increases in $5,000 increments. The dollar limit is reduced in the case of retirement before the social security retirement age and increases in the case of retirement after the social security retirement age.

A special rule applies to governmental defined benefit plans. In the case of such plans, the defined benefit dollar limit is reduced in the case of retirement before age 62 and increased in the case of retirement after age 65. In addition, there is a floor on early retirement benefits. Pursuant to this floor, the minimum benefit payable at age 55 is $75,000.

In the case of a defined contribution plan, the limit on annual is additions if the lesser of (1) 25 percent of compensation[93] or (2) $35,000 (for 2001).

In applying the limits on contributions and benefits, plans of the same employer are aggregated. That is, all defined benefit plans of the same employer are treated as a single plan, and all defined contribution plans of the same employer are treated as a single plan. Under Treasury regulations, multiemployer plans are not aggregated with other multiemployer plans. However, if an employer maintains both a plan that is not a multiemployer plan and a mulitemployer plan, the plan that is not a multiemployer plan is aggregated with the multiemployer plan to the extent that benefits provided under the multiemployer plan are provided with respect to a common participant.[94]

REASONS FOR CHANGE

The Committee understands that, because pension benefits under multiemployer plans are typically based upon factors other than compensation, the section 415 benefit limits frequently result in benefit reductions for employees in industries in which wages vary annually.

EXPLANATION OF PROVISION

Under the provision, the 100 percent of compensation defined benefit plan limit does not apply to multiemployer plans. With respect to aggregation of multiemployer plans with other plans, the bill provides that multiemployer plans are not aggregated with single-employer defined benefit plans maintained by an employer contributing to the multiemployer plan for purposes of applying the 100 percent of compensation limit to such single-employer plan.

[93] Another provision increases this limit to 100 percent of compensation.
[94] Treas. Reg. sec. 1.415–8(e).

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(d) Investment of employee contributions in 401(k) plans (Sec. 655 of the bill and Sec. 1524(b) of the Taxpayer Relief Act of 1997)

PRESENT LAW

The Employee Retirement Income Security Act of 1974, as amended ("ERISA") prohibits certain employee benefit plans from acquiring securities or real property of the employer who sponsors the plan if, after the acquisition, the fair market value of such securities and property exceeds 10 percent of the fair market value of plan assets. The 10-percent limitation does not apply to any "eligible individual account plans" that specifically authorize such investments. Generally, eligible individual account plans are defined contribution plans, including plans containing a cash or deferred arrangement ("401(k) plans").

The term "eligible individual account plan" does not include the portion of a plan that consists of elective deferrals (and earnings on the elective deferrals) made under section 401(k) if elective deferrals equal to more than one percent of any employee's eligible compensation are required to be invested in employer securities and employer real property. Eligible compensation is compensation that is eligible to be deferred under the plan. The portion of the plan that consists of elective deferrals (and earnings thereon) is still treated as an individual account plan, and the 10-percent limitation does not apply, as long as elective deferrals (and earnings thereon) are not required to be invested in employer securities or employer real property.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply if individual account plans are a small part of the employer's retirement plans. In particular, that rule does not apply to an individual account plan for a plan year if the value of the assets of all individual account plans maintained by the employer do not exceed 10 percent of the value of the assets of all pension plans maintained by the employer (determined as of the last day of the preceding plan year). Multiemployer plans are not taken into account in determining whether the value of the assets of all individual account plans maintained by the employer exceed 10 percent of the value of the assets of all pension plans maintained by the employer. The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan does not apply to an employee stock ownership plan as defined in section 4975(e)(7) of the Internal Revenue Code.

The rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan applies to elective deferrals for plan years beginning after December 31, 1998 (and earnings thereon). It does not apply with respect to earnings on elective deferrals for plan years beginning before January 1, 1999.

REASONS FOR CHANGE

The Committee believes that the effective date provided in the Taxpayer Relief Act of 1997 with respect to the rule excluding elective deferrals (and earnings thereon) from the definition of individual account plan has produced unintended results.

EXPLANATION OF PROVISION

The provision modifies the effective date of the rule excluding certain elective deferrals (and earnings thereon) from the definition of individual account plan by providing that the rule does not apply to any elective deferral used to acquire an interest in the income or gain from employer securities or employer real property acquired (1) before January 1, 1999, or (2) after such date pursuant to a written contract which was binding on such date and at all times thereafter.

EFFECTIVE DATE

The provision is effective as if included in the section of the Taxpayer Relief Act of 1997 that contained the rule excluding certain elective deferrals (and earnings thereon).

(e) Prohibited allocations of stock in an S corporation ESOP (Sec. 656 of the bill and Secs. 409 and 4979A of the Code)

PRESENT LAW

The Small Business Job Protection Act of 1996 allowed qualified retirement plan trusts described in section 401(a) to own stock in an S corporation. That Act treated the plan's share of the S corporation's income (and gain on the disposition of the stock) as includible in full in the trust's unrelated business taxable income ("UBTI").

The Tax Relief Act of 1997 repealed the provision treating items of income or loss of an S corporation as UBTI in the case of an employee stock ownership plan ("ESOP"). Thus, the income of an S corporation allocable to an ESOP is not subject to current taxation.

Present law provides a deferral of income on the sales of certain employer securities to an ESOP (Sec. 1042). A 50-percent excise tax is imposed on certain prohibited allocations of securities acquired by an ESOP in a transaction to which section 1042 applies. In addition, such allocations are currently includible in the gross income of the individual receiving the prohibited allocation.

REASONS FOR CHANGE

In enacting the 1996 Act provision allowing ESOPs to be shareholders of S corporations, the Congress intended to encourage employee ownership of closely-held businesses, and to facilitate the establishment of ESOPs by S corporations. At the same time, the Congress provided that all income flowing through to an ESOP (or other tax-exempt S shareholder), and gains and losses from the disposition of the stock, was treated as unrelated business taxable income. This treatment was consistent with the premise underlying the S corporation rules that all income of an S corporation (including all gains of the sale of the stock of the corporation) should be subject to a shareholder-level tax.

In enacting the present-law rule relating to S corporation ESOPs in 1997, the Congress was concerned that the 1996 Act rule imposed double taxation on such ESOPs and ESOP participants. The Congress believed such a result was inappropriate. Since the enactment of the 1997 Act, however, the Committee has become aware that the present-law rules allow inappropriate deferral and possibly tax avoidance in some cases.

The Committee continues to believe that S corporations should be able to encourage employee ownership through an ESOP. The Committee does not believe, however, that ESOPs should be used by S corporations owners to obtain inappropriate tax deferral or avoidance.

Specifically, the Committee believes that the tax deferral opportunities provided by an S corporation ESOP should be limited to those situations in which there is broad-based employee coverage under the ESOP and the ESOP benefits rank-and-file employees as well as highly compensated employees and historical owners.

EXPLANATION OF PROVISION

In general

Under the provision, if there is a nonallocation year with respect to an ESOP maintained by an S corporation: (1) the amount allocated in a prohibited allocation to an individual who is a disqualified person is treated as distributed to such individual (i.e., the value of the prohibited allocation is includible in the gross income of the individual receiving the prohibited allocation); (2) an excise tax is imposed on the S corporation equal to 50 percent of the amount involved in a prohibited allocation; and (3) an excise tax is imposed on the S corporation with respect to any synthetic equity owned by a disqualified person.[95]

It is intended that the provision will limit the establishment of ESOPs by S corporations to those that provide broad-based employee coverage and that benefit rank-and-file employees as well as highly compensated employees and historical owners.

Definition of nonallocation year

A nonallocation year means any plan year of an ESOP holding shares in an S corporation if, at any time during the plan year, disqualified persons own at least 50 percent of the number of outstanding shares of the S corporation.

A person is a disqualified person if the person is either (1) a member of a "deemed 20-percent shareholder group" or (2) a "deemed 10-percent shareholder." A person is a member of a "deemed 20-percent shareholder group" if the aggregate number of deemed-owned shares of the person and his or her family members is at least 20 percent of the number of deemed-owned shares of stock in the S corporation.[96] A person is a deemed 10-percent shareholder if the person is not a member of a deemed 20-percent

[95] The plan is not disqualified merely because an excise tax is imposed under the provision.

[96] A family member of a member of a "deemed 20-percent shareholder group" with deemed owned shares is also treated as a disqualified person.

shareholder group and the number of the person's deemed-owned shares is at least 10 percent of the number of deemed-owned shares of stock of the corporation.

In general, "deemed-owned shares" means: (1) stock allocated to the account of an individual under the ESOP, and (2) an individual's share of unallocated stock held by the ESOP. An individual's share of unallocated stock held by an ESOP is determined in the same manner as the most recent allocation of stock under the terms of the plan.

For purposes of determining whether there is a nonallocation year, ownership of stock generally is attributed under the rules of section 318,[97] except that: (1) the family attribution rules is modified to include certain other family members, as described below, (2) option attribution do not apply (but instead special rules relating to synthetic equity described below apply), and (3) "deemed-owned shares" held by the ESOP are treated as held by the individual with respect to whom they are deemed owned.

Under the provision, family members of an individual include (1) the spouse[98] of the individual, (2) an ancestor or lineal descendant of the individual or his or her spouse, (3) a sibling of the individual (or the individual's spouse) and any lineal descendant of the brother or sister, and (4) the spouse of any person described in (2) or (3).

The provision contains special rules applicable to synthetic equity interests. Except to the extent provided in regulations, the stock on which a synthetic equity interest is based is treated as outstanding stock of the S corporation and as deemed-owned shares of the person holding the synthetic equity interest if such treatment results in the treatment of any person as a disqualified person or the treatment of any year as a nonallocation year. Thus, for example, disqualified persons for a year includes those individuals who are disqualified persons under the general rule (i.e., treating only those shares held by the ESOP as deemed-owned shares) and those individuals who are disqualified individuals if synthetic equity interests are treated as deemed-owned shares.

"Synthetic equity" means any stock option, warrant, restricted stock, deferred issuance stock right, or similar interest that gives the holder the right to acquire or receive stock of the S corporation in the future. Except to the extent provided in regulations, synthetic equity also includes a stock appreciation right, phantom stock unit, or similar right to a future cash payment based on the value of such stock or appreciation in such value.[99]

Ownership of synthetic equity is attributed in the same manner as stock is attributed under the provision (as described above). In addition, ownership of synthetic equity is attributed under the rules of section 318(a)(2) and (3) in the same manner as stock.

[97] These attribution rules also apply to stock treated as owned by reason of the ownership of synthetic equity.

[98] As under section 318, an individual's spouse is not treated as a member of the individual's family if the spouses are legally separated.

[99] The provisions relating to synthetic equity do not modify the rules relating to S corporations, e.g., the circumstances in which options or similar interests are treated as creating a second class of stock.

Definition of prohibited allocation

An ESOP of an S corporation is required to provide that no portion of the assets of the plan attributable to (or allocable in lieu of) S corporation stock may, during a nonallocation year, accrue (or be allocated directly or indirectly under any qualified plan of the S corporation) for the benefit of a disqualified person. A "prohibited allocation" refers to violations of this provision. A prohibited allocation occurs, for example, if income on S corporation stock held by an ESOP is allocated to the account of an individual who is a disqualified person.

Application of excise tax

In the case of a prohibited allocation, the S corporation is liable for an excise tax equal to 50 percent of the amount of the allocation. For example, if S corporation stock is allocated in a prohibited allocation, the excise tax equals 50 percent of the fair market value of such stock.

A special rule applies in the case of the first nonallocation year, regardless of whether there is a prohibited allocation. In that year, the excise tax also applies to the fair market value of the deemed-owned shares of any disqualified person held by the ESOP, even though those shares are not allocated to the disqualified person in that year.

As mentioned above, the S corporation also is liable for an excise tax with respect to any synthetic equity interest owned by any disqualified person in a nonallocation year. The excise tax is 50 percent of the value of the shares on which synthetic equity is based.

Treasury regulations

The Treasury Department is given the authority to prescribe such regulations as may be necessary to carry out the purposes of the provision.

EFFECTIVE DATE

The provision generally is effective with respect to plan years beginning after December 31, 2002. In the case of an ESOP established after July 11, 2000, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the provision is effective with respect to plan years ending after July 11, 2000.

(f) Automatic rollovers of certain mandatory distributions (Sec. 657 of the bill and Secs. 401(a)(31) and 402(f)(1) of the Code and Sec. 404(c) of ERISA)

PRESENT LAW

If a qualified retirement plan participant ceases to be employed by the employer that maintains the plan, the plan may distribute the participant's nonforfeitable accrued benefit without the consent of the participant and, if applicable, the participant's spouse, if the present value of the benefit does not exceed $5,000. If such an involuntary distribution occurs and the participant subsequently returns to employment covered by the plan, then service taken into account in computing benefits payable under the plan after the return need not include service with respect to which a benefit was involuntarily distributed unless the employee repays the benefit.

Generally, a participant may roll over an involuntary distribution from a qualified plan to an IRA or to another qualified plan. Before making a distribution that is eligible for rollover, a plan administrator must provide the participant with a written explanation of the ability to have the distribution rolled over directly to an IRA or another qualified plan and the related tax consequences.

REASONS FOR CHANGE

The Committee believes that present law does not adequately encourage rollovers of involuntary distribution amounts. Failure to roll over these amounts can significantly reduce the retirement income that would otherwise be accumulated by workers who change jobs frequently. The Committee believes that making a direct rollover the default option for involuntary distributions will increase the preservation of retirement savings.

EXPLANATION OF PROVISION

The provision makes a direct rollover the default option for involuntary distributions that exceed $1,000 and that are eligible rollover distributions from qualified retirement plans. The distribution must be rolled over automatically to a designated IRA, unless the participant affirmatively elects to have the distribution transferred to a different IRA or a qualified plan or to receive it directly.

The written explanation provided by the plan administrator is required to explain that an automatic direct rollover will be made unless the participant elects otherwise. The plan administrator is also required to notify the participant in writing (as part of the general written explanation or separately) that the distribution may be transferred without cost to another IRA.

The provision amends the fiduciary rules of ERISA so that, in the case of an automatic direct rollover, the participant is treated as exercising control over the assets in the IRA upon the earlier of (1) the rollover of any portion of the assets to another IRA, or (2) one year after the automatic rollover.

The provision directs the Secretary of Labor to issue safe harbors under which the designation of an institution and investment of funds in accordance with the provision are deemed to satisfy the requirements of section 404(a) of ERISA. In addition, the provision authorizes and directs the Secretary of the Treasury and the Secretary of Labor to give consideration to providing special relief with respect to the use of low-cost individual retirement plans for purposes of the provision and for other uses that promote the preservation of tax-qualified retirement assets for retirement income purposes.

EFFECTIVE DATE

The provision applies to distributions that occur after the Department of Labor has adopted final regulations implementing the provision.

(g) Clarification of treatment of contributions to a multiemployer plan (Sec. 658 of the bill)

PRESENT LAW

Employer contributions to one or more qualified retirement plans are deductible subject to certain limits. In general, contributions are deductible for the taxable year of the employer in which the contributions are made. Under a special rule, an employer may be deemed to have made a contribution on the last day of the preceding taxable year if the contribution is on account of the preceding taxable year and is made not later than the time prescribed by law for filing the employer's income tax return for that taxable year (including extensions).[100]

A change in method of accounting includes a change in the overall plan of accounting for gross income or deductions or a change in the treatment of any material item used in such overall plan. A material item is any item that involves the proper time for the inclusion of the item in income or taking of a deduction.[101] A change in method of accounting does not include correction of mathematical or posting errors, or errors in the computation of tax liability. Also, a change in method of accounting does not include adjustment of any item of income or deduction that does not involve the proper time for the inclusion of the item of income or the taking of a deduction. A change in method of accounting also does not include a change in treatment resulting from a change in underlying facts.

REASONS FOR CHANGE

The Committee is aware that the interaction of the rules regarding employer contributions to qualified retirement plans and the rules regarding what constitutes a method of accounting has resulted in some uncertainty for taxpayers. Specifically, there is some uncertainty regarding whether the determination of whether a contribution to a multiemployer pension plan is on account of a prior year under section 404(a)(6) is considered a method of accounting. The uncertainty regarding this issue has resulted in disputes between taxpayers and the IRS that the Committee believes can be avoided by eliminating the uncertainty.

EXPLANATION OF PROVISION

The provision clarifies that a determination of whether contributions to multiemployer pension plans are on account of a prior year under section 404(a)(6) is not a method of accounting. Thus, any taxpayer that begins to deduct contributions to multiemployer plans as provided in section 404(a)(6) has not changed its method of accounting and is not subject to an adjustment under section 481. The provision is intended to respect, not disturb, the effect of the statute of limitations. The provision is not intended to permit, as of the end of the taxable year, aggregate deductions for contributions to a qualified plan in excess of the amounts actually contributed or deemed contributed to the plan by the taxpayer. The Sec-

[100] Section 404(a)(6).
[101] Treas. Reg. sec. 1.446–1(e)(2)(ii)(a).

retary of the Treasury is authorized to promulgate regulations to clarify that, in the aggregate, no taxpayer will be permitted deductions in excess of amounts actually contributed to multiemployer plans, taking into account the provisions of section 404(a)(6).

No inference is intended regarding whether the determination of whether a contribution to a multiemployer pension plan on account of a prior year under section 404(a)(6) is a method of accounting prior to the effective date of the provision.

EFFECTIVE DATE

The provision is effective after the date of enactment.

(h) Notice of significant reduction in plan benefit accruals (Sec. 659 of the bill and new Sec. 4980F of the Code)

PRESENT LAW

Section 204(h) of Title I of ERISA provides that a defined benefit pension plan or a money purchase pension plan may not be amended so as to provide for a significant reduction in the rate of future benefit accrual, unless, after adoption of the plan amendment and not less than 15 days before the effective date of the plan amendment, the plan administrator provides a written notice ("section 204(h) notice"), setting forth the plan amendment (or a summary of the amendment written in a manner calculated to be understood by the average plan participant) and its effective date. The plan administrator must provide the section 204(h) notice to each plan participant, each alternate payee under an applicable qualified domestic relations order ("QDRO"), and each employee organization representing participants in the plan. The applicable Treasury regulations[102] provide, however, that a plan administrator need not provide the section 204(h) notice to any participant or alternate payee whose rate of future benefit accrual is reasonably expected not to be reduced by the amendment, nor to an employee organization that does not represent a participant to whom the section 204(h) notice must be provided. In addition, the regulations provide that the rate of future benefit accrual is determined without regard to optional forms of benefit, early retirement benefits, retirement-type subsidiaries, ancillary benefits, and certain other rights and features.

A covered amendment generally will not become effective with respect to any participants and alternate payees whose rate of future benefit accrual is reasonably expected to be reduced by the amendment but who do not receive a section 204(h) notice. An amendment will become effective with respect to all participants and alternate payees to whom the section 204(h) notice was required to be provided if the plan administrator (1) has made a good faith effort to comply with the section 204(h) notice requirements, (2) has provided a section 204(h) notice to each employee organization that represents any participant to whom a section 204(h) notice was required to be provided, (3) has failed to provide a section 204(h) notice to no more than a de minimis percentage of participants and alternate payees to whom a section 204(h) notice was re-

[102] Treas. Reg. sec. 1.411(d)–6.

quired to be provided, and (4) promptly upon discovering the oversight, provides a section 204(h) notice to each omitted participant and alternate payee.

The Internal Revenue Code does not require any notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual.

REASONS FOR CHANGE

The Committee is aware of recent significant publicity concerning conversions of traditional defined benefit pension plans to "cash balance" plans, with particular focus on the impact such conversions have on affected workers. Several legislative proposals have been introduced to address some of the issues relating to such conversions.

The Committee believes that employees are entitled to meaningful disclosure concerning plan amendments that may result in reductions of future benefit accruals. The Committee has determined that present law does not require employers to provide such disclosure, particularly in cases where traditional defined benefit plans are converted to cash balance plans. The Committee also believes that any disclosure requirements applicable to plan amendments should strike a balance between providing meaningful disclosure and avoiding the imposition of unnecessary administrative burdens on employers, and that this balance may best be struck through the regulatory process with an opportunity for input from affected parties.

The Committee understands that there are other issues in addition to disclosure that have arisen with respect to the conversion of defined benefit plans to cash balance or other hybrid plans, particularly situations in which plan participants do not earn any additional benefit under the plan for some time after conversion (called a "wear away"). The Committee believes that this issue should be further studied by the Treasury in order to provide guidance to the Congress.

EXPLANATION OF PROVISION

The provision adds to the Internal Revenue Code a requirement that the plan administrator of a defined benefit pension plan furnish a written notice concerning a plan amendment that provides for a significant reduction in the rate of future benefit accrual, including any elimination or reduction of an early retirement benefit or retirement-type subsidy.[103] The notice is required to set forth: (1) a summary of the plan amendment and the effective date of the amendment; (2) a statement that the amendment is expected to significantly reduce the rate of future benefit accrual; (3) a description of the classes of employees reasonably expected to be affected by the reduction in the rate of future benefit accrual; (4) examples illustrating the plan changes for these classes of employees; (5) in

[103] The provision also modifies the present-law notice requirement contained in section 204(h) of Title I of ERISA to provide that an applicable pension plan may not be amended to provide for a significant reduction in the rate of future benefit accrual in the event of a failure by the plan administrator to exercise due diligence in meeting a notice requirement similar to the notice requirement that the provision adds to the Internal Revenue Code. In addition, the provision expands the current ERISA notice requirement regarding significant reductions in normal retirement benefit accrual rates to early retirement benefits and retirement-type subsidies.

the event of an amendment that results in the significant restructuring of the plan benefit formula, as determined under regulations prescribed by the Secretary (a "significant restructuring amendment"), a notice that the plan administrator will provide, generally no later than 15 days prior to the effective date of the amendment, a "benefit estimation tool kit" (described below) that will enable employees who have completed at least one year of participation to personalize the illustrative examples; and (6) notice of each affected participant's right to request, and of the procedures for requesting, an annual benefit statement as provided under present law. The plan administrator is required to provide the notice not less than 45 days before the effective date of the plan amendment.

The notice requirement does not apply to governmental plans or church plans with respect to which an election to have the qualified plan participation, vesting, and funding rules apply has not been made (Sec. 410(d)).

The plan administrator is required to provide this generalized notice to each affected participant and each affected alternate payee. For purposes of the provision, an affected participant or alternate payee is a participant or alternate payee to whom the significant reduction in the rate of future benefit accrual is reasonably expected to apply.

As noted above, the provision requires the plan administrator to provide a benefit estimation tool kit, no later than 15 days prior to the amendment effective date, to a participant for whom the amendment may reasonably be expected to produce a significant reduction in the rate of future benefit accrual if the amendment is a significant restructuring amendment. The plan administrator is not required to provide this benefit estimation tool kit to any participant who has less than one year of participation in the plan.

The benefit estimation tool kit is designed to enable participants to estimate benefits under the old and new plan provisions. The provision permits the tool kit to be in the form of software (for use at home, at a workplace kiosk, or on a company intranet), worksheets, or calculation instructions, or other formats to be determined by the Secretary of the Treasury. The tool kit is required to include any necessary actuarial assumptions and formulas and to permit the participant to estimate both a single life annuity at appropriate ages and, when available, a lump sum distribution. The tool kit is required to disclose the interest rate used to compute a lump sum distribution and whether the value of early retirement benefits is included in the lump sum distribution.

The provision requires the benefit estimation tool kit to accommodate employee-provided variables with respect to age, years of service, retirement age, covered compensation, and interest rate (when variable rates apply). The tool kit is required to permit employees to recalculate estimated benefits by changing the values of these variables. The provision does not require the tool kit to accommodate employee variables with respect to qualified domestic relations orders, factors that result in unusual patterns of credited service (such as extended time away from the job), special benefit formulas for unusual situations, offsets from other plans, and forms of annuity distributions.

In the case of a significant restructuring amendment that occurs in connection with a business disposition or acquisition transaction and within one year following the date of the transaction, the provision requires the plan administrator to provide the benefit estimation tool kit prior to the date that is 12 months after the date on which the generalized notice of the amendment is given to the affected participants.

The provision permits a plan administrator to provide any notice required under the provision to a person designated in writing by the individual to whom it would otherwise be provided. In addition, the provision authorizes the Secretary of the Treasury to allow any notice required under the provision to be provided by using new technologies, provided that at least one option for providing notice is not dependent upon new technologies.

The provision imposes on a plan administrator that fails to comply with the notice requirement an excise tax equal to $100 per day per omitted participant and alternate payee. No excise tax is imposed during any period during which any person subject to liability for the tax did not know that the failure existed and exercised reasonable diligence to meet the notice requirement. In addition, no excise tax is imposed on any failure if any person subject to liability for the tax exercised reasonable diligence to meet the notice requirement and such person provides the required notice during the 30–day period beginning on the first date such person knew, or exercising reasonable diligence would have known, that the failure existed. Also, if the person subject to liability for the excise tax exercised reasonable diligence to meet the notice requirement, the total excise tax imposed during a taxable year of the employer will not exceed $500,000. Furthermore, in the case of a failure due to reasonable cause and not to willful neglect, the Secretary of the Treasury is authorized to waive the excise tax to the extent that the payment of the tax is excessive relative to the failure involved.

The provision directs the Secretary of the Treasury to issue, not later than one year after the date of enactment, regulations with respect to early retirement benefits or retirement-type subsidies, the determination of a significant restructuring amendment, and the examples that are required under the generalized notice and the benefit estimation tool kit.

In addition, the provision directs the Secretary of the Treasury to prepare a report on the effects of significant restructurings of plan benefit formulas of traditional defined benefit plans. Such study is to examine the effect of such restructurings on longer service participants, including the incidence and effects of “wear away” provisions under which participants earn no additional benefits for a period of time after the restructuring. The Secretary is directed to submit such report, together with recommendations thereon, to the Committee on Ways and Means and the Committee on Education and the Workforce of the House of Representatives and the Committee on Finance and the Committee on Health, Education, Labor, and Pensions of the Senate as soon as practicable, but not later than one year after the date of enactment.

EFFECTIVE DATE

The provision is effective for plan amendments taking effect on or after the date of enactment. The period for providing any notice required under the provision will not end before the last day of the 3–month period following the date of enactment. Prior to the issuance of Treasury regulations, a plan is treated as meeting the requirements of the provision if the plan makes a good faith effort to comply with such requirements.

5. Reducing regulatory burdens

(a) Modification of timing of plan valuations (Sec. 661 of the bill and Sec. 412 of the Code)

PRESENT LAW

Under present law, plan valuations are generally required annually for plans subject to the minimum funding rules. Under proposed Treasury regulations, except as provided by the Commissioner, the valuation must be as of a date within the plan year to which the valuation refers or within the month prior to the beginning of that year.[104]

REASONS FOR CHANGE

While plan valuations are necessary to ensure adequate funding of defined benefit pension plans, they also create administrative burdens for employers. The Committee believes that permitting limited elections to use as the valuation date for a plan year any date within the immediately preceding plan year in the case of well-funded plans strikes an appropriate balance between funding concerns and employer concerns about plan administrative burdens.

EXPLANATION OF PROVISION

The provision incorporates into the statute the proposed regulation regarding the date of valuations. The provision also provides, as an exception to this general rule, that the valuation date with respect to a plan year may be any date within the immediately preceding plan year if, as of such date, plan assets are not less than 125 percent of the plan's current liability. Information determined as of such date is required to be adjusted actuarially, in accordance with Treasury regulations, to reflect significant differences in plan participants. An election to use a prior plan year valuation date, once made, could only be revoked with the consent of the Secretary.

EFFECTIVE DATE

The provision is effective for plan years beginning after December 31, 2001.

[104] Prop. Treas. Reg. sec. 1.412(c)(9)–1(b)(1).

(b) ESOP dividends may be reinvested without loss of dividend deduction (Sec. 662 of the bill and Sec. 404 of the Code)

PRESENT LAW

An employer is entitled to deduct certain dividends paid in cash during the employer's taxable year with respect to stock of the employer that is held by an employee stock ownership plan ("ESOP"). The deduction is allowed with respect to dividends that, in accordance with plan provisions, are (1) paid in cash directly to the plan participants or their beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) used to make payments on loans (including payments of interest as well as principal) that were used to acquire the employer securities (whether or not allocated to participants) with respect to which the dividend is paid.

The Secretary may disallow the deduction for any ESOP dividend if he determines that the dividend constitutes, in substance, an evasion of taxation (Sec. 404(k)(5)).

REASONS FOR CHANGE

The Committee believes that it is appropriate to provide incentives for the accumulation of retirement benefits and expansion of employee ownership. The Committee has determined that the present-law rules concerning the deduction of dividends on employer stock held by an ESOP discourage employers from permitting such dividends to be reinvested in employer stock and accumulated for retirement purposes.

EXPLANATION OF PROVISION

In addition to the deductions permitted under present law for dividends paid with respect to employer securities that are held by an ESOP, an employer is entitled to deduct the applicable percentage of dividends that, at the election of plan participants or their beneficiaries, are (1) payable in cash directly to plan participants or beneficiaries, (2) paid to the plan and subsequently distributed to the participants or beneficiaries in cash no later than 90 days after the close of the plan year in which the dividends are paid to the plan, or (3) paid to the plan and reinvested in qualifying employer securities. The applicable percentage is 25 percent for 2002 through 2004, 50 percent for 2005 through 2007, 75 percent for 2008 through 2010 and 100 percent for 2011 and thereafter.

EFFECTIVE DATE

The provision is effective for taxable years beginning after December 31, 2001.

(c) Repeal transition rule relating to certain highly compensated employees (Sec. 663 of the bill and Sec. 1114(c)(4) of the Tax Reform Act of 1986)

PRESENT LAW

Under present law, for purposes of the rules relating to qualified plans, a highly compensated employee is generally defined as an employee[105] who (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 $85,000 (for 2001) or (b) at the election of the employer, had compensation in excess of $85,000 for the preceding year and was in the top 20 percent of employees by compensation for such year.

Under a rule enacted in the Tax Reform Act of 1986, a special definition of highly compensated employee applies for purposes of the nondiscrimination rules relating to qualified cash or deferred arrangements ("section 401(k) plans") and matching contributions. This special definition applies to an employer incorporated on December 15, 1924, that meets certain specific requirements.

REASONS FOR CHANGE

The Committee believes it appropriate to repeal the special definition of highly compensated employee in light of the substantial modification of the general definition of highly compensated employee in the Small Business Job Protection Act of 1996.

EXPLANATION OF PROVISION

The provision repeals the special definition of highly compensated employee under the Tax Reform Act of 1986. Thus, the present-law definition applies.

EFFECTIVE DATE

The provision is effective for plan years beginning after December 31, 2001.

(d) Employees of tax-exempt entities (Sec. 664 of the bill)

PRESENT LAW

The Tax Reform Act of 1986 provided that nongovernmental tax-exempt employers were not permitted to maintain a qualified cash or deferred arrangement ("section 401(k) plan"). This prohibition was repealed, effective for years beginning after December 31, 1996, by the Small Business Job Protection Act of 1996.

Treasury regulations provide that, in applying the nondiscrimination rules to a section 401(k) plan (or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan), the employer may treat as excludable those employees of a tax-exempt entity who could not participate in the arrangement due to the prohibition on maintenance of a section 401(k) plan by such entities. Such employees may be disregarded only if more than 95 percent of the employees who could partici-

[105] An employee includes a self-employed individual.

pate in the section 401(k) plan benefit under the plan for the plan year.[106]

Tax-exempt charitable organizations may maintain a tax-sheltered annuity (a "section 403(b) annuity") that allows employees to make salary reduction contributions.

REASONS FOR CHANGE

The Committee believes it appropriate to modify the special rule regarding the treatment of certain employees of a tax-exempt organization as excludable for section 401(k) plan nondiscrimination testing purposes in light of the provision of the Small Business Job Protection Act of 1996 that permits such organizations to maintain section 401(k) plans.

EXPLANATION OF PROVISION

The Treasury Department is directed to revise its regulations under section 410(b) to provide that employees of a tax-exempt charitable organization who are eligible to make salary reduction contributions under a section 403(b) annuity may be treated as excludable employees for purposes of testing a section 401(k) plan, or a section 401(m) plan that is provided under the same general arrangement as the section 401(k) plan of the employer if (1) no employee of such tax-exempt entity is eligible to participate in the section 401(k) or 401(m) plan and (2) at least 95 percent of the employees who are not employees of the charitable employer are eligible to participate in such section 401(k) plan or section 401(m) plan.

The revised regulations will be effective for years beginning after December 31, 1996.

EFFECTIVE DATE

The provision is effective on the date of enactment.

(e) Treatment of employer-provided retirement advice (Sec. 665 of the bill and Sec. 132 of the Code)

PRESENT LAW

Under present law, certain employer-provided fringe benefits are excludable from gross income (Sec. 132) and wages for employment tax purposes. These excludable fringe benefits include working condition fringe benefits and de minimis fringes. In general, a working condition fringe benefit is any property or services provided by an employer to an employee to the extent that, if the employee paid for such property or services, such payment is allowable as a deduction as a business expense. A de minimis fringe benefit is any property or services provided by the employer the value of which, after taking into account the frequency with which similar fringes are provided, is so small as to make accounting for it unreasonable or administratively impracticable.

In addition, if certain requirements are satisfied, up to $5,250 annually of employer-provided educational assistance is excludable from gross income (Sec. 127) and wages. This exclusion expires

[106] Treas. Reg. sec. 1.410(b)–6(g).

with respect to courses beginning after December 31, 2001.[107] Education not excludable under section 127 may be excludable as a working condition fringe.

There is no specific exclusion under present law for employer-provided retirement planning services. However, such services may be excludable as employer-provided educational assistance or a fringe benefit.

REASONS FOR CHANGE

In order to plan adequately for retirement, individuals must anticipate retirement income needs and understand how their retirement income goals can be achieved. Employer-sponsored plans are a key part of retirement income planning. The Committee believes that employers sponsoring retirement plans should be encouraged to provide retirement planning services for their employees in order to assist them in preparing for retirement.

EXPLANATION OF PROVISION

Qualified retirement planning services provided to an employee and his or her spouse by an employer maintaining a qualified plan are excludable from income and wages. 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. The exclusion is intended to allow employers to provide advice and information regarding retirement planning. The exclusion is not limited to information regarding the qualified 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 is not intended to apply to services that may be related to retirement planning, such as tax preparation, accounting, legal or brokerage services.

EFFECTIVE DATE

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

(f) Reporting simplification (Sec. 666 of the bill)

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 re-

[107] The exclusion does not apply with respect to graduate-level courses.

quired annual return.[108] 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 two 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.

REASONS FOR CHANGE

The Committee believes that it is appropriate to simplify the reporting requirements for plans eligible to file Form 5500–EZ, because such plans do not cover any employees of the business owner.

EXPLANATION OF PROVISION

The Secretary of the Treasury is directed to modify the annual return filing requirements with respect to plans that satisfy the eligibility requirements for Form 5500–EZ to provide that if the total value of the plan assets of such a plan as of the end of the plan year and all prior plan years beginning on or after January 1, 1994, does not exceed $250,000, the plan administrator is not required to file a return.

EFFECTIVE DATE

The provision is effective on January 1, 2002.

[108] Treas. Reg. sec. 301.6058–1(a).

(g) Improvement to Employee Plans Compliance Resolution System (Sec. 667 of the bill)

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.[109] 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.

REASONS FOR CHANGE

The Committee commends the IRS for the establishment of EPCRS and agrees with the IRS that EPCRS should be updated and improved periodically. The Committee believes that future improvements should facilitate use of the compliance and correction

[109] Rev. Proc. 2001–17, 2001–7 I.R.B. 589.

programs by small employers and expand the flexibility of the programs.

EXPLANATION OF PROVISION

The Secretary of the Treasury is 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 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.

(h) Repeal of the multiple use test (Sec. 668 of the bill and Sec. 401(m) of the Code)

PRESENT LAW

Elective deferrals under a qualified cash or deferred arrangement ("section 401(k) plan") are subject to a special annual nondiscrimination test ("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.

Employer matching contributions and after-tax employee contributions under a defined contribution plan also are subject to a special annual nondiscrimination test ("ACP test"). The ACP test compares the actual deferral percentages ("ACPs") of the highly compensated employee group and the nonhighly compensated employee group. The ACP for each group generally is the average of the contribution percentages separately calculated for the employees in the group who are eligible to make after-tax employee contributions or who are eligible for an allocation of matching contributions for all or a portion of the relevant plan year. Each eligible employee's contribution percentage generally is the employee's aggregate after-tax employee contributions and matching contributions for the year divided by the employee's compensation for the year.

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.

For any year in which (1) at least one highly compensated employee is eligible to participate in an employer's plan or plans that are subject to both the ADP test and the ACP test, (2) the plan subject to the ADP test satisfies the ADP test but the ADP of the highly compensated employee group exceeds 125 percent of the ADP of the nonhighly compensated employee group, and (3) the plan subject to the ACP test satisfies the ACP test but the ACP of the highly compensated employee group exceeds 125 percent of the ACP of the nonhighly compensated employee group, an additional special nondiscrimination test ("multiple use test") applies to the elective deferrals, employer matching contributions, and after-tax employee contributions. The plan or plans generally satisfy the multiple use test if the sum of the ADP and the ACP of the highly compensated employee group does not exceed the greater of (1) the sum of (A) 1.25 times the greater of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the lesser of the ADP or the ACP of the nonhighly compensated employee group, or (2) the sum of (A) 1.25 times the lesser of the ADP or the ACP of the nonhighly compensated employee group, and (B) two percentage points plus (but not more than two times) the greater of the ADP or the ACP of the nonhighly compensated employee group.

REASONS FOR CHANGE

The Committee believes that the ADP test and the ACP test are adequate to prevent discrimination in favor of highly compensated employees under 401(k) plans and has determined that the multiple use test unnecessarily complicates 401(k) plan administration.

EXPLANATION OF PROVISION

The provision repeals the multiple use test.

EFFECTIVE DATE

The provision is effective for years beginning after December 31, 2001.

(i) Flexibility in nondiscrimination, coverage, and line of business rules (Sec. 669 of the bill and Secs. 401(a)(4), 410(b), and 414(r) of the Code)

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.

REASONS FOR CHANGE

It has been brought to the attention of the Committee that some plans are unable to satisfy the mechanical tests used to determine compliance with the nondiscrimination and line of business requirements solely as a result of relatively minor plan provisions. The Committee believes that, in such cases, it may be appropriate to expand the consideration of facts and circumstances in the application of the mechanical tests.

EXPLANATION OF PROVISION

The Secretary of the Treasury is directed to modify, on or before December 31, 2001, 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 is directed to provide by regulation applicable to years beginning after December 31, 2001, that a plan is deemed to satisfy the nondiscrimination requirements of section 401(a)(4) if the plan satisfies the pre-1994 facts and circumstances test, satisfies the conditions prescribed by the Secretary to appropriately limit the availability of such test, and is submitted to the Secretary for a determination of whether it satisfies such test (to the extent provided by the Secretary).

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

EFFECTIVE DATE

The provision relating to the line of business requirements under section 414(r) is effective on the date of enactment. The provision relating to the nondiscrimination requirements under section 401(a)(4) is effective on the date of enactment, except that any condition of availability prescribed by the Secretary is not effective before the first year beginning not less than 120 days after the date on which such condition is prescribed. The provision relating to the minimum coverage requirements under section 410(b) is effective for years beginning after December 31, 2001, except that any condition of availability prescribed by the Secretary by regulation will not apply before the first year beginning not less than 120 days after the date on which such condition is prescribed.

(j) Extension to all governmental plans of moratorium on application of certain nondiscrimination rules applicable to State and local government plans (Sec. 670 of the bill, 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 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.

REASONS FOR CHANGE

The Committee believes that application of the nondiscrimination and minimum participation rules to governmental plans is unnecessary and inappropriate in light of the unique circumstances under which such plans and organizations operate. Further, the Committee believes that it is appropriate to provide for consistent application of the minimum coverage, nondiscrimination, and minimum participation rules for governmental plans.

EXPLANATION OF PROVISION

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

EFFECTIVE DATE

The provision is effective for plan years beginning after December 31, 2001.

6. Other ERISA provisions

(a) Extension of PBGC missing participants program (Sec. 681 of the bill and Secs. 206(f) and 4050 of ERISA)

PRESENT LAW

The plan administrator of a defined benefit pension plan that is subject to Title IV of ERISA, is maintained by a single employer, and terminates under a standard termination is required to distribute the assets of the plan. With respect to a participant whom the plan administrator of a single employer plan cannot locate after a diligent search, the plan administrator satisfies the distribution requirement only by purchasing irrevocable commitments from an insurer to provide all benefit liabilities under the plan 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.

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.

REASONS FOR CHANGE

The Committee recognizes that no statutory provision or formal regulatory guidance exists concerning an appropriate method of handling missing participants in terminated multiemployer plans or defined contribution plans and other plans not subject to the PBGC termination insurance program. Therefore, sponsors of these plans face uncertainty with respect to missing participants. The Committee believes that it is appropriate to extend the established PBGC missing participant program to these plans in order to reduce uncertainty for plan sponsors and increase the likelihood that missing participants will receive their retirement benefits.

EXPLANATION OF PROVISION

The provision directs the PBGC to prescribe for terminating multiemployer plans rules similar to the present-law missing participant rules applicable to terminating single employer plans that are subject to Title IV of ERISA.

In addition, 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 to defined contribution plans, defined benefit plans that have no more than 25 active participants and are maintained by professional service employers, and the portion of defined benefit 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 from terminating plans that occur after the PBGC has adopted final regulations implementing the provision.

(b) Reduce PBGC premiums for small and new plans (Secs. 682 and 683 of the bill and 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 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.

REASONS FOR CHANGE

The Committee believes that reducing the PBGC premiums for new plans and small plans will help encourage the establishment of defined benefit pension plans, particularly by small employers.

EXPLANATION OF PROVISION

Reduced flat-rate premiums for new plans of small employers

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

A small employer is a contributing sponsor that, on the first day of the plan year, has 100 or fewer employees. For this purpose, all employees of the members of the controlled group of the contributing sponsor are taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributes, employees of all contributing sponsors (and their controlled group members) are taken into account in determining whether the plan is a plan of a small employer.

A new plan means 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) has not established or maintained a plan subject to PBGC coverage with respect to which benefits were accrued for substantially the same employees as are in the new plan.

Reduced variable-rate PBGC premium for new plans

The bill provides that the variable-rate premium is 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 is a percentage of the variable premium otherwise due, as follows: 0 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 is defined as described above under the flat-rate premium provision 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 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 taken into account. In the case of a plan to which more than one unrelated contributing sponsor contributes, employees of all contributing sponsors (and their controlled group members) are taken into account in determining whether the plan is 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 is effective with respect to plans established after December 31, 2001. The reduction of the variable-rate premium for small plans is effective with respect to plan years beginning after December 31, 2001.

(c) Authorization for PBGC to pay interest on premium overpayment refunds (Sec. 684 of the bill and Sec. 4007(b) of ERISA)

PRESENT LAW

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

REASONS FOR CHANGE

The Committee believes that an employer or other person who overpays PBGC premiums should receive interest on a refund of the overpayment.

EXPLANATION OF PROVISION

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

(d) Rules for substantial owner benefits in terminated plans (Sec. 685 of the bill and 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.

REASONS FOR CHANGE

The Committee believes that the present-law rules concerning limitations on guaranteed benefits for substantial owners are overly complicated and restrictive and thus may discourage some small business owners from establishing defined benefit pension plans.

EXPLANATION OF PROVISION

The bill 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 depends on the number of years the plan has been in effect. The majority owner's guaranteed benefit is 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 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, 2001.

7. Miscellaneous provisions

(a) Tax treatment of electing Alaska Native Settlement Trusts (section 691 of the Bill and new sections 646 and 6039H of the Code, modifying Code sections including 1(e), 301, 641, 651, 661, and 6034A))

PRESENT LAW

An Alaska Native Settlement Corporation ("ANC") may establish a Settlement Trust ("Trust") under section 39 of the Alaska Native Claims Settlement Act ("ANCSA")[110] and transfer money or other property to such Trust for the benefit of beneficiaries who constitute all or a class of the shareholders of the ANC, to promote the health, education and welfare of the beneficiaries and preserve the heritage and culture of Alaska Natives.

With certain exceptions, once an ANC has made a conveyance to a Trust, the assets conveyed shall not be subject to attachment, distraint, or sale or execution of judgment, except with respect to the lawful debts and obligations of the Trust.

The Internal Revenue Service ("IRS") has indicated that contributions to a Trust constitute distributions to the beneficiary-shareholders at the time of the contribution and are treated as dividends to the extent of earnings and profits as provided under section 301 of the Code.[111] Also, a Trust and its beneficiaries are generally taxed subject to applicable trust rules.[112]

REASONS FOR CHANGE

The Committee is concerned that present law may inhibit many ANCs from establishing Settlement Trusts, due to the IRS present law treatment of a contribution by an ANC to a Trust as a dividend to the extent the ANC has current or accumulated earnings and profits in the year of the contribution. So long as the ANC shareholders or beneficiaries of the Trust do not receive the money or other property that is contributed to the Trust, the Committee believes it is appropriate to allow the transfer to the Trust without causing dividend treatment.

The Committee also believes it is appropriate for a Settlement Trust to be able to accumulate its earnings at the lowest individual tax rate rather than the higher rates that generally apply to trusts, and to distribute earnings taxed at that rate to Alaska Native beneficiaries without additional taxation to the beneficiaries.

At the same time, the Committee believes it is appropriate to require a Settlement Trust to elect to obtain the benefits of the new provisions, and to provide safeguards for such electing Trusts that prevent the benefits from being used by persons other than Alaska Natives, or from being used to circumvent basic tax law provisions in an unintended manner.

[110] 43 U.S.C. 1601 et. seq. A Settlement Trust is subject to certain limitations under ANCSA, including that it may not operate a business. 43 U.S.C. 1629e(b).

[111] See, e.g., PLR 9824014; PLR 9433021; PLR 9329026 and PLR 9326019.

[112] See Subchapter J of the Code (Secs. 641 et. seq.); Treas. Reg. Sec. 1.301.7701–4.

EXPLANATION OF PROVISION

The provision allows an election under which special rules will apply in determining the income tax treatment of an electing Trust and of its beneficiaries. An electing Trust will pay tax on its income at the lowest rate specified for ordinary income of an individual (or corresponding lower capital gains rate). The provision also specifies the treatment of distributions by an electing Trust to beneficiaries, the reporting requirements associated with such an election, and the consequences of disqualification for these benefits due to the allowance of certain impermissible dispositions of Trust interests or ANC stock.

Under the provision, a trust that is a Settlement Trust established by an Alaska Native Corporation under section 39 of ANCSA may make an election for its first taxable year ending after the date of enactment of the provision to be subject to the rules of the provision rather than otherwise applicable income tax rules. If the election is in effect, no amount will be included in the gross income of a beneficiary of such Trust by reason of a contribution to the Trust.[113] In addition, ordinary income of the electing Trust, whether accumulated or distributed, will be taxed only to the Trust (and not to beneficiaries) at the lowest individual tax rate for ordinary income. Capital gains of the electing Trust will similarly be taxed to the Trust at the capital gains rate applicable to individuals subject to such lowest rate. These rates will apply, rather than the higher rates generally applicable to trusts or to higher tax bracket beneficiaries. The election is made on a one-time basis only. The benefits of the election will terminate, however, and other special rules will apply, if the electing Trust or the sponsoring ANC fail to satisfy the restrictions on transferability of Trust beneficial interests or of ANC stock.

The treatment to beneficiaries of amounts distributed by an electing Trust depends upon the amount of the distribution. Solely for purposes of determining what amount has been distributed and thus which treatment applies under these rules, the amount of any distribution of property is the fair market value of the property at the time of the distribution.[114]

Amounts distributed by an electing Trust during any taxable year are excludable from the gross income of the recipient beneficiary to the extent of (1) the taxable income of the Trust for the taxable year and all prior taxable years for which an election was in effect (decreased by any income tax paid by the Trust with respect to the income) plus (2) any amounts excluded from gross income of the Trust under section 103 for those periods.[115]

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[113] If the ANC transfers appreciated property to the Trust, section 311(b) of the Code will apply to the ANC, as under present law, so that the ANC will recognize gain as if it had sold the property for fair market value. The Trust takes the property with a fair market value basis, pursuant to section 301(d) of the Code.

[114] Section 661 of the Code, which provides a deduction to the trust for certain distributions, does not apply to an electing Trust under the provision unless the election is terminated by disqualification. Similarly, the inclusion provisions of section 662 of the Code, relating to amounts to be included in income of beneficiaries, also do not apply to a qualified electing Trust.

[115] In the case of any such excludable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary would be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

If distributions to beneficiaries exceed the excludable amounts described above, then such excess distributions are reported and taxed to beneficiaries as if distributed by the ANC in the year of the distribution by the electing Trust to the extent the ANC then has current or accumulated earnings and profits, and are treated as dividends to beneficiaries.[116] Additional distributions in excess of the current or accumulated earnings and profits of the ANC are treated by the beneficiaries as distributions by the Trust in excess of the distributable net income of the Trust for such year.[117]

The fiduciary of an electing Trust must report to the IRS, with the Trust tax return, the amount of distributions to each beneficiary, and the tax treatment to the beneficiary of such distributions under the provision (either as exempt from tax to the beneficiary, or as a distribution deemed made by the ANC). The electing Trust must also furnish such information to the ANC. In the case of distributions that are treated as if made by the ANC, the ANC must then report such amounts to the beneficiaries and must indicate whether they are dividends or not, in accordance with the earnings and profits of the ANC. The reporting thus required by an electing Trust will be in lieu of, and will satisfy, the reporting requirements of section 6034A (and such other reporting requirements as the Secretary of the Treasury may deem appropriate).

The earnings and profits of an ANC will not be reduced by the amount of its contributions to an electing Trust at the time of the contributions. However, the ANC earnings and profits will be reduced as and when distributions are thereafter made by the electing Trust that are taxed to beneficiaries under the provision as dividends from the ANC to the Trust beneficiaries.

If in any taxable year the beneficial interests in the electing Trust may be disposed of to a person in a manner that would not be permitted under ANCSA if the interests were Settlement Common Stock (generally, to a person other than an Alaska Native),[118] then the special provisions applicable to electing Trusts, including the favorable ordinary income tax rate and corresponding lower capital gains tax rate, cease to apply as of the beginning of such taxable year. The distributable net income of the Trust is increased up to the amount of current and accumulated earnings and profits of the ANC as of the end of that year, but such increase shall not exceed the fair market value of the assets of the Trust as of the date the beneficial interests of the Trust became disposable.[119]

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[116] The treatment of such amounts distributed by an electing Trust as a dividend applies even if all or any part of the contributions by an ANC to a Trust would not have been dividends at the time of the contribution under present law; for example, because the ANC had no current or accumulated earnings and profits, or because the contribution was made from Alaska Native Fund amounts that may not have been taxable. See 43 U.S.C. 1605.

[117] Such distributions would not be taxable to the beneficiaries. In the case of any such nontaxable distribution that involves a distribution of property other than cash, the basis of such property in the hands of the recipient beneficiary will generally be the adjusted basis of the property in the hands of the Trust, unless the Trust makes an election to pay tax, in which case the basis in the hands of the beneficiary will be the fair market value of the property. See Code sections 643(e) and 643(e)(3).

[118] Under ANSCA, Settlement Common Stock is subject to restrictions on transferability. If changes are made to permit additional transferability of such stock, then the Settlement Common Stock is cancelled and Replacement Common Stock is issued. See 43 U.S.C. 1602(p), 1606(h) and 1629c.

[119] To the extent the earnings and profits of the ANC increase distributable net income of the Trust under this provision, the ANC will have a corresponding adjustment reducing its earnings and profits.

Thereafter, the Trust and its beneficiaries are generally subject to the rules of subchapter J and to the generally applicable trust income tax rates. Thus, the increase in distributable net income will result in the Trust being taxed at regular trust rates to the extent the recomputed distributable net income is not distributed to beneficiaries; and beneficiaries will be taxed to the extent there are distributions. Normal reporting rules applicable to trusts and their beneficiaries will apply. The basis of any property distributed to beneficiaries will also be determined under normal trust rules. The same rules apply if any stock of the ANC may be disposed of to a person in a manner that would not be permitted under ANCSA if the stock were Settlement Common Stock and the ANC makes a transfer to the Trust.

The provision contains a special loss disallowance rule that reduces any loss that would otherwise be recognized by a shareholder upon the disposition of a share of stock of a sponsoring ANC by a "per share loss adjustment factor." This factor reflects the aggregate of all contributions to an electing Trust sponsored by such ANC made on or after the first day the trust is treated as an electing Trust, expressed on a per share basis and determined as of the day of each such contribution.

The special loss disallowance rule is intended to prevent the allowance of noneconomic losses if the ANC stock owned by beneficiaries ever becomes transferable in any type of transaction that could cause the recognition of taxable gain or loss, (including a redemption by the ANC) where the basis of the stock in the hands of the beneficiary (or in the hands of any transferee of a beneficiary) fails to reflect the allocable reduction in corporate value attributable to amounts transferred by the ANC into the Trust.

EFFECTIVE DATE

The provision is effective for taxable years of Settlement Trusts, their beneficiaries, and sponsoring Alaska Native Corporations ending after the date of enactment, and to contributions made to electing Settlement Trusts during such year and thereafter.

C. COMPLIANCE WITH CONGRESSIONAL BUDGET ACT

(Secs. 695–696 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to IRAs and pensions which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to IRAs and pensions which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

VII. ALTERNATIVE MINIMUM TAX

A. Individual Alternative Minimum Tax Relief

(Sec. 701 of the bill and Sec. 55 of the Code)

PRESENT LAW

Present law imposes an alternative minimum tax ("AMT") on individuals to the extent that the tentative minimum tax exceeds the regular tax. An individual's tentative minimum tax generally is an amount equal to the sum of (1) 26 percent of the first $175,000 ($87,500 in the case of a married individual filing a separate return) of alternative minimum taxable income ("AMTI") in excess of an exemption amount and (2) 28 percent of the remaining AMTI. AMTI is the individual's taxable income adjusted to take account of specified preferences and adjustments.

The AMT exemption amounts are: (1) $45,000 in the case of married individuals filing a joint return and surviving spouses; (2) $33,750 in the case of other unmarried individuals; and (3) $22,500 in the case of married individuals filing a separate return, estates and trusts. The exemption amounts are phased out by an amount equal to 25 percent of the amount by which the individual's AMTI exceeds (1) $150,000 in the case of married individuals filing a joint return and surviving spouses, (2) $112,500 in the case of other unmarried individuals, and (3) $75,000 in the case of married individuals filing separate returns or an estate or a trust. The exemption amounts, the threshold phase-out amounts, and rate brackets are not indexed for inflation.

REASONS FOR CHANGE

The Committee is concerned about the projected increase in the number of individuals who will be affected by the individual alternative minimum tax in future years. The provision will reduce the number of individuals who would otherwise be affected by the minimum tax.

EXPLANATION OF PROVISION

The provision increases the AMT exemption amount for married couples filing a joint return and surviving spouses by $4,000. The AMT exemption amounts for other individuals (i.e., unmarried individuals and married individuals filing a separate return) are increased by $2,000.

EFFECTIVE DATE

The provision applies to taxable years beginning after December 31, 2000, and before January 1, 2007.

B. Compliance With Congressional Budget Act

(Secs. 711 and 712 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to the alternative minimum tax which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to the alternative minimum tax which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

VIII. OTHER PROVISIONS

A. Modification to Corporate Estimated Tax Requirements

(Sec. 801 of the bill)

PRESENT LAW

In general, corporations are required to make quarterly estimated tax payments of their income tax liability (section 6655). For a corporation whose taxable year is a calendar year, these estimated tax payments must be made by April 15, June 15, September 15, and December 15.

REASONS FOR CHANGE

The Committee believes that it is appropriate to modify these corporate estimated tax requirements.

EXPLANATION OF PROVISION

With respect to corporate estimated tax payments due on September 17, 2001,[120] 30 percent is required to be paid by September 17, 2001, and 70 percent is required to be paid by October 1, 2001. With respect to corporate estimated tax payments due on September 15, 2004, 80 percent is required to be paid by September 15, 2004, and 20 percent is required to be paid by October 1, 2004.

EFFECTIVE DATE

The provision is effective on the date of enactment.

B. Authority To Postpone Certain Tax-Related Deadlines by Reason of Presidentially Declared Disaster

(Sec. 802 of the bill and Sec. 7508A of the Code)

PRESENT LAW

The Secretary of the Treasury may specify that certain deadlines are postponed for a period of up to 90 days in the case of a taxpayer determined to be affected by a Presidentially declared disaster.[121] The deadlines that may be postponed are the same as are postponed by reason of service in a combat zone. If the Secretary extends the period of time for filing income tax returns and for paying income tax, the Secretary must abate related interest for that same period of time.[122]

[120] September 15, 2001 will be a Saturday. Under present law, payments required to be made on a Saturday must be made no later than the next banking day.
[121] Section 7508A.
[122] Section 6404(h).

REASONS FOR CHANGE

Disasters can cause a variety of tax-related problems, such as the loss of records and the inability to meet filing deadlines. Although the IRS attempts to address such issues under present law, the Committee believes that the ability of the IRS to deal with disaster-related tax issues would be enhanced by the creation of a Disaster Response Team to provide guidance to taxpayers affected by disasters. In addition, the Committee believes increasing the maximum time period for which the Secretary may postpone certain deadlines in the case of a taxpayer determined to be affected by a Presidentially declared disaster will help taxpayers in dealing with disasters.

EXPLANATION OF PROVISION

The bill directs the Secretary to create in the IRS a Disaster Response Team, which, in coordination with the Federal Emergency Management Agency, is to assist taxpayers in clarifying and resolving tax matters associated with a Presidentially declared disaster. One of the duties of the Disaster Response Team is to postpone certain tax-related deadlines for up to 120 days in appropriate cases for taxpayers determined to be affected by a Presidentially declared disaster.

It is anticipated that the Disaster Response Team would be staffed by IRS employees with relevant knowledge and experience. The Committee anticipates that the Disaster Response Team would staff a toll-free number dedicated to responding to taxpayers affected by a Presidentially declared disaster and provide relevant information via the IRS website.

EFFECTIVE DATE

The provision is effective on the date of enactment.

C. COMPLIANCE WITH CONGRESSIONAL BUDGET ACT

(Secs. 811–812 of the bill)

PRESENT LAW

Reconciliation is a procedure under the Congressional Budget Act of 1974 (the "Budget Act") by which Congress implements spending and tax policies contained in a budget resolution. The Budget Act contains numerous rules enforcing the scope of items permitted to be considered under the budget reconciliation process. One such rule, the so-called "Byrd rule," was incorporated into the Budget Act in 1990. The Byrd rule, named after its principal sponsor, Senator Robert C. Byrd, is contained in section 313 of the Budget Act. The Byrd rule generally permits members to raise a point of order against extraneous provisions (those which are unrelated to the goals of the reconciliation process) from either a reconciliation bill or a conference report on such bill.

Under the Byrd rule, a provision is considered to be extraneous if it falls under one or more of the following six definitions:

(1) It does not produce a change in outlays or revenues;

(2) It produces an outlay increase or revenue decrease when the instructed committee is not in compliance with its instructions;

(3) It is outside of the jurisdiction of the committee that submitted the title or provision for inclusion in the reconciliation measure;

(4) It produces a change in outlays or revenues which is merely incidental to the nonbudgetary components of the provision;

(5) It would increase net outlays or decrease revenues for a fiscal year beyond those covered by the reconciliation measure; and

(6) It recommends changes in Social Security.

REASONS FOR CHANGE

This title of the bill contains language sunsetting each provision in the title in order to preclude each such provision from violating the fifth definition of extraneity of the Byrd rule. Inclusion of the language restoring each such provision would undo the sunset language; therefore, the "restoration" language is itself subject to the Byrd rule.

EXPLANATION OF PROVISION

Sunset of provisions

To ensure compliance with the Budget Act, the bill provides that all provisions of, and amendments made by, the bill relating to corporate estimated taxes and authority to postpone tax deadlines because of disasters which are in effect on September 30, 2011, shall cease to apply as of the close of September 30, 2011.

Restoration of provisions

All provisions of, and amendments made by, the bill relating to corporate estimated taxes and authority to postpone tax deadlines because of disasters which were terminated under the sunset provision shall begin to apply again as of October 1, 2011, as provided in each such provision or amendment.

**ESTIMATED BUDGET EFFECTS OF THE "RESTORING EARNINGS TO LIFT INDIVIDUALS AND EMPOWER FAMILIES ('RELIEF') ACT OF 2001," [1]
AS ORDERED REPORTED BY THE COMMITTEE ON FINANCE ON MAY 15, 2001**

Fiscal Years 2001 - 2011

[Millions of Dollars]

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
Marginal Rate Reduction Provisions														
1. Create new 10% bracket for the first $6,000 of taxable income for singles, first $10,000 for heads of households, and first $12,000 for married couples; and index beginning in 2007	tyba 12/31/00	-9,359	-59,158	-40,223	-40,336	-40,201	-40,203	-40,650	-41,256	-41,844	-42,430	-43,023	-229,480	-438,683
2. Reduce the various income tax rates (39.6% rate reduced to 38.6% in 2002 through 2004, 37.6% in 2005 through 2006, and 36% in 2007 and thereafter; 36% rate reduced to 35% in 2002 through 2004, and 34% in 2005 through 2006, and 33% in 2007 and thereafter; 31% rate reduced to 30% in 2002 through 2004, and 29% in 2005 through 2006, and 28% in 2007 and thereafter; 28% rate reduced to 27% in 2002 through 2004, and 26% in 2005 through 2006, and 25% in 2007 and thereafter)	tyba 12/31/01	---	-11,718	-17,237	-17,754	-29,956	-35,888	-49,568	-56,060	-57,147	-58,310	-59,523	-112,553	-393,161
3. Increase starting point of "Pease" cutback on itemized deductions to the personal exemption phaseout level	tyba 12/31/08	---	---	---	---	---	---	---	---	-431	-891	-952	---	-2,274
4. Repeal the phaseout of personal exemptions	tyba 12/31/08	---	---	---	---	---	---	---	---	-1,563	-3,310	-3,685	---	-8,558
Total of Marginal Rate Reductions Provisions		**-9,359**	**-70,876**	**-57,460**	**-58,090**	**-70,157**	**-76,091**	**-90,218**	**-97,316**	**-100,985**	**-104,941**	**-107,183**	**-342,033**	**-842,676**
Increase the Child Tax Credit From $500 to $600 in 2001 through 2003, $700 in 2004 through 2006, $800 in 2007 through 2009, $900 in 2010, and $1,000 in 2011 and Thereafter; Make Refundable up to Greater of 15% of Earned Income in Excess of $10,000 or Present Law; Allow Credit Permanently Against the AMT; Repeal AMT Offset of Refundable Credits	**tyba 12/31/00**	**-583**	**-10,438**	**-11,071**	**-12,711**	**-17,187**	**-18,278**	**-19,770**	**-24,125**	**-24,561**	**-25,357**	**-30,625**	**-70,268**	**-194,706**
Marriage Penalty Relief Provisions														
1. Standard deduction set at 2 times single for married filing jointly, phased in over 5 years beginning in 2006	tyba 12/31/05	---	---	---	---	---	-754	-1,435	-2,347	-2,865	-2,997	-2,397	-754	-12,795
2. 15% rate bracket set at 2 times single for married filing jointly, phased in over 5 years beginning in 2006	tyba 12/31/05	---	---	---	---	---	-2,346	-4,331	-4,853	-4,606	-4,412	-4,008	-2,346	-24,556

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
3. EIC Modification and Simplification - $3,000 increase in joint returns beginning and ending income level for phaseout beginning in 2002 and indexed thereafter; simplify definition of earned income; use AGI instead of modified AGI; conform definition of qualifying child and tie-breaker rules to those in JCT simplification study; and allow math error procedure with Federal Case registry data beginning in 2004 [2]	tyba 12/31/01	---	-21	-2,088	-2,571	-2,567	-2,565	-2,593	-2,553	-2,521	-2,499	-2,477	-9,812	-22,456
Total of Marriage Penalty Relief Provisions		**---**	**-21**	**-2,088**	**-2,571**	**-2,567**	**-5,665**	**-8,359**	**-9,753**	**-9,992**	**-9,908**	**-8,882**	**-12,912**	**-59,807**
Education Provisions														
1. Education IRAs - increase the annual contribution limit to $2,000; allow education IRA contributions for special needs beneficiaries above the age of 18; allow corporations and other entities to contribute to education IRAs; allow contributions until April 15 of the following year; allow a taxpayer to exclude Ed IRA distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; repeal excise tax on contributions made to education IRA when contribution made by anyone on behalf of same beneficiary to QTP; modify phaseout range for married taxpayers; allow tax-free expenditures for elementary and secondary school expenses	tyba 12/31/01	---	-203	-365	-460	-560	-666	-777	-891	-1,011	-1,134	-1,285	-2,253	-7,351
2. Qualified Tuition Plans - tax-free distributions from State plans; allow private institutions to offer prepaid tuition plans, tax-deferred in 2002, with tax-free distributions beginning in 2004; allow a taxpayer to exclude QTP distributions from gross income and claim the HOPE or Lifetime Learning credits as long as they are not used for the same expenses; expand definition of family member to include cousins; allow tax-free distributions for actual living expenses	tyba 12/31/01	---	-24	-53	-81	-111	-141	-170	-200	-234	-256	-283	-410	-1,553
3. Employer Provided Assistance - permanently extend the exclusion for undergraduate courses and graduate level courses	cba 12/31/01	---	-519	-720	-760	-804	-852	-904	-958	-1,012	-1,068	-1,127	-3,656	-8,725
4. Student loan interest - eliminate the 60-month rule; increase phaseout ranges to $50,000-$65,000 single/$100,000-$130,000 joint; indexed for inflation after 2002	ipa 12/31/01	---	-170	-245	-262	-277	-289	-305	-321	-338	-356	-375	-1,243	-2,937
5. Eliminate the tax on awards under the National Health Corps Scholarship program and F. Edward Hebert Armed Forces Health Professions Scholarship program	tyba 12/31/01	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-5	-9
6. Increase arbitrage rebate exception for governmental bonds used to finance qualified school construction from $10 million to $15 million	bia 12/31/01	---	[3]	-3	-5	-6	-11	-15	-16	-17	-18	-19	-25	-109

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
7. Issuance of tax-exempt private activity bonds for qualified education facilities with annual State volume caps the greater of $10 per resident or $5 million	bia 12/31/01	---	-5	-19	-38	-61	-88	-120	-155	-191	-224	-257	-212	-1,160
8. Above-the-line deduction for qualified higher education expenses in 2002 through 2005	tyba 12/31/01	---	-1,535	-2,063	-3,054	-3,408	-852	---	---	---	---	---	-10,912	-10,912
9. $500 credit for interest paid on higher education loans in 2009 through 2011	tyba 12/31/08	---	---	---	---	---	---	---	---	-202	-275	-281	---	-758
Total of Education Provisions		---	**-2,457**	**-3,469**	**-4,661**	**-5,228**	**-2,900**	**-2,292**	**-2,542**	**-3,006**	**-3,332**	**-3,628**	**-18,716**	**-33,514**
Estate and Gift Provisions														
1. Phase In Repeal of Estate and Generation-Skipping Transfer Taxes - beginning in 2002, repeal the 5% "bubble" (which phases out the lower rates) and repeal rates in excess of 50%; in 2003, repeal rates in excess of 49%, in 2004 in excess of 48%, in 2005 in excess of 47%, in 2006 in excess of 46%, and in 2007 through 2010 in excess of 45%; reduce State tax credit rates by 50% in 2002, 55% in 2003, 56% in 2004, and repeal in 2005; increase the unified credit to $1 million in 2002 and 2003, $2 million in 2004, $3 million in 2005 through 2008, $3.5 million in 2009, and $4 million in 2010 (lifetime gift exclusion remains at $1 million); repeal section 2057 in 2004; repeal estate and generation-skipping transfer taxes in 2011; retain gift tax in 2011 and thereafter with $1 million lifetime gift exclusion at 40% gift tax rate; carryover basis applies to transfers at death after 12/31/10 of assets fully owned by decedents, except: (1) $1.3 million of additional basis and certain loss carryforwards of the decedent are allowed to be added to carryover basis, and (2) an additional $3 million of basis is allowed to be added to carryover basis of assets going to surviving spouse; certain reporting requirements on bequests	dda & gma 12/31/01	---	---	-4,128	-4,365	-12,805	-14,835	-16,099	-18,382	-19,868	-24,121	-29,636	-36,133	-144,239
2. Expand Availability of Estate Tax Exclusion for Conservation Easements - repeal the 25-mile and 10-mile limits, and clarify the date for determining easement compliance	dda 12/31/00	---	-3	-19	-28	-29	-30	-32	-34	-36	-39	-42	-109	-292
3. Modifications to Generation-Skipping Transfer Tax Rules -														
a. Deemed allocation of the generation-skipping transfer tax exemption to lifetime transfers to trusts that are not direct skips	ta 12/31/00	---	-1	-3	-4	-4	-4	-4	-4	-4	-4	-4	-16	-36
b. Retroactive allocation of the generation-skipping tax exemption	generally 12/31/00	---	-1	-4	-6	-6	-6	-6	-6	-6	-6	-6	-23	-53
c. Severing of trusts holding property having an inclusion ratio of greater than zero	---	*Included in Item 3.b.*												
d. Modification of certain valuation rules	---	*Included in Item 3.b.*												
e. Relief from late elections	---	*Included in Item 3.b.*												

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
f. Substantial compliance	---	Included in Item 3.b.												
4. Expand Availability of Installment Payment Relief Under Section 6166 to:														
a. Qualified lending and finance business interests	dda 12/31/01	---	---	-103	-84	-64	-43	-21	-22	-24	-25	-27	-295	-413
b. Certain holding company stock	dda 12/31/01	---	---	-171	-140	-107	-72	-34	-47	-49	-42	-45	-491	-688
Total of Estate and Gift Provisions		**---**	**-5**	**-4,428**	**-4,627**	**-13,015**	**-14,990**	**-16,196**	**-18,495**	**-19,987**	**-24,237**	**-29,760**	**-37,067**	**-145,721**
Pension and IRA Provisions														
Individual Retirement Arrangement Provisions														
1. Modification of IRA Contribution Limits - increase the maximum contribution limit for traditional and Roth IRAs to: $2,500 in 2002 through 2005, $3,000 in 2006 and 2007, $3,500 in 2008 and 2009, $4,000 in 2010, $5,000 in 2011	tyba 12/31/01	---	-191	-441	-549	-662	-992	-1,347	-1,728	-2,150	-2,575	-3,291	-2,835	-13,928
2. IRA Catch-Up Contributions - increase maximum contribution limits for traditional and Roth IRAs for individuals age 50 and above by $500 in 2002, $1,000 in 2006, $1,500 in 2010, and $2,000 in 2011	tyba 12/31/01	---	-73	-161	-186	-212	-301	-377	-378	-384	-434	-401	-934	-2,908
3. Deemed IRAs under employee plans	pyba 12/31/02	Negligible Revenue Effect												
4. Allow tax-free withdrawals from IRAs for charitable purposes	tyba 12/31/09	---	---	---	---	---	---	---	---	---	-318	-508	---	-826
Total of Individual Retirement Arrangement Provisions		---	-264	-602	-735	-874	-1,293	-1,724	-2,106	-2,534	-3,327	-4,200	-3,769	-17,662
Provisions for Expanding Coverage														
1. Increase contribution and benefit limits:														
a. Increase limitation on exclusion for elective deferrals to: $11,000 in 2002 and increase by $500 each year thereafter until $15,000 in 2010; index thereafter [4] [5]	yba 12/31/01	---	---	---	-116	-175	-194	-331	-406	-431	-566	-535	-485	-2,754
b. Increase limitation on SIMPLE elective contributions to: $7,000 in 2002 and 2003, $8,000 in 2004 and 2005, $9,000 in 2006 and 2007, and $10,000 in 2008; index thereafter [4] [5]	yba 12/31/01	---	-10	-15	-25	-30	-39	-45	-55	-59	-63	-65	-119	-406
c. Increase defined benefit dollar limit to: $150,000 in 2002 through 2004, $160,000 in 2005, and index thereafter	yba 12/31/01	---	-14	-25	-8	-20	-8	1	-21	-30	-30	-31	-75	-185
d. Lower early retirement age to 62; lower normal retirement age to 65	yba 12/31/01	---	-3	-4	-4	-5	-5	-5	-5	-5	-5	-6	-21	-47
e. Increase indexing on annual addition limitation for defined contribution plans in $1,000 increments [4]	yba 12/31/01	---	-4	-9	-12	-13	-6	-8	-12	-14	-15	-13	-43	-105
f. Increase qualified plan compensation limit to $180,000 in 2002, $190,000 in 2003, $200,000 in 2004 and 2005; index in $5,000 increments thereafter [4]	yba 12/31/01	---	---	-38	-57	-62	-46	-61	-53	-46	-49	-27	-203	-439

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
g. Increase limits on deferrals under deferred compensation plans of State and local governments and tax-exempt organizations to: $9,000 in 2002 and increase by $500 each year thereafter until $11,000 in 2006, then $12,000 in 2007, $13,000 in 2008, $14,000 in 2009, and $15,000 in 2010; index thereafter [4] [5]	yba 12/31/01	---	-9	-16	-23	-27	-38	-53	-79	-102	-132	-140	-112	-617
2. Plan loans for S corporation owners, partners, and sole proprietors	yba 12/31/01	---	-21	-32	-34	-36	-39	-41	-44	-47	-49	-52	-162	-395
3. Modification of top-heavy rules	yba 12/31/01	---	-3	-6	-7	-8	-9	-10	-11	-12	-14	-15	-32	-95
4. Elective deferrals not taken into account for purposes of deduction limits (25% in 2002 through 2010, and 100% in 2011 and thereafter	yba 12/31/01	---	-20	-37	-43	-46	-50	-53	-57	-60	-63	-133	-195	-561
5. Repeal of coordination requirements for deferred compensation plans of State and local governments and tax-exempt organizations [4]	yba 12/31/01	---	-16	-28	-28	-27	-26	-26	-27	-26	-26	-27	-126	-258
6. Elimination of user fee for certain requests regarding small employer pension plans with at least one non-highly compensated employee [6]	rma 12/31/01	---	-5	-8	---	---	---	---	---	---	---	---	-13	-13
7. Definition of compensation for purposes of deduction limits [4]	yba 12/31/01	---	-1	-3	-3	-3	-3	-4	-4	-4	-4	-4	-14	-33
8. Increase stock bonus and profit sharing plan deduction limit from 15% to 25% [4]	tyba 12/31/01	---	-25	-47	-55	-60	-64	-69	-74	-79	-84	-45	-252	-602
9. Option to treat elective deferrals as after-tax Roth contributions	yba 12/31/03	---	---	---	148	190	152	101	23	-72	-180	-300	490	62
10. Nonrefundable credit to certain individuals for elective deferrals and IRA contributions (sunset 12/31/06)	tyba 12/31/01	---	-1,036	-2,096	-1,963	-1,856	-1,746	-920	-102	-91	-89	-86	-8,698	-9,987
11. Small business (20 or fewer employees) tax credit for new qualified retirement plan contributions - first 3 years of the plan	cpoii tyba 12/31/02	---	---	-70	-185	-297	-351	-362	-368	-378	-395	-415	-904	-2,822
12. Small business (100 or fewer employees) tax credit for new retirement plan expenses - first 3 years of the plan	[7]	---	-3	-12	-21	-29	-29	-29	-27	-26	-25	-25	-94	-225
13. Treatment of nonresident aliens engaged in international transportation services	tyba 12/31/01	---	-2	-7	-7	-7	-8	-8	-8	-8	-8	-8	-31	-71
Total of Provisions for Expanding Coverage		---	-1,172	-2,453	-2,443	-2,511	-2,509	-1,923	-1,330	-1,490	-1,797	-1,927	-11,089	-19,553
Provisions for Enhancing Fairness for Women														
1. Additional catch-up contributions for individuals age 50 and above - increase the otherwise applicable contribution limit by $500 in 2002 through 2004, $1,000 in 2005 and 2006, $2,000 in 2007, $3,000 in 2008, $4,000 in 2009, and $7,500 in 2010 and thereafter (nondiscrimination rules would not apply) [4]	tyba 12/31/01	---	-62	-88	-87	-124	-120	-139	-139	-119	-100	-96	-481	-1,075
2. Equitable treatment for contributions of employees to defined contribution plans (raise the 25% of compensation limit to 50% in 2002 through 2010, and 100% in 2011 and thereafter) [4]	yba 12/31/01	---	-22	-41	-47	-51	-54	-58	-57	-58	-61	-89	-214	-537

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
3. Faster vesting of certain employer matching contributions	cf pyba 12/31/01	Negligible Revenue Effect												
4. Simplify and update the minimum distribution rules by modifying post-death distribution rules	yba 12/31/01	---	[3]	-1	-1	-2	-2	-2	-2	-2	-3	-3	-6	-18
5. Clarification of tax treatment of division of section 457 plan benefits upon divorce	tdapma 12/31/01	Negligible Revenue Effect												
6. Modification of safe harbor relief for hardship withdrawals from 401(k) plans	yba 12/31/01	Negligible Revenue Effect												
7. Waiver of tax on nondeductible contributions for domestic or similar workers	tyba 12/31/01	---	[3]	[3]	-1	-2	-4	-6	-8	-10	-12	-14	-8	-57
Total of Provisions for Enhancing Fairness for Women		---	-84	-130	-136	-179	-180	-205	-206	-189	-176	-202	-709	-1,687
Provisions for Increasing Portability for Participants														
1. Rollovers allowed among governmental section 457 plans, section 403(b) plans, and qualified plans	da 12/31/01	---	27	-4	-4	-5	-5	-5	-6	-6	-7	-7	10	-21
2. Rollovers of IRAs to workplace retirement plans	da 12/31/01	Negligible Revenue Effect												
3. Rollovers of after-tax retirement plan contributions	dma 12/31/01	Negligible Revenue Effect												
4. Waiver of 60-day rule	da 12/31/01	Negligible Revenue Effect												
5. Treatment of forms of qualified plan distributions	yba 12/31/01	Negligible Revenue Effect												
6. Rationalization of restrictions on distributions	da 12/31/01	Negligible Revenue Effect												
7. Purchase of service credit in governmental defined benefit plans	ta 12/31/01	Negligible Revenue Effect												
8. Employers may disregard rollovers for cash-out amounts	da 12/31/01	Negligible Revenue Effect												
9. Minimum distribution and inclusion requirements for section 457 plans; modification of transition rules for existing 457 plans	da 12/31/01 and tyea DOE	Considered in Other Provisions												
Total of Provisions for Increasing Portability for Participants		---	27	-4	-4	-5	-5	-5	-6	-6	-7	-7	10	-21
Provisions for Strengthening Pension Security and Enforcement														
1. Phase-in repeal of 160% of current liability funding limit; extend maximum deduction rule	pyba 12/31/01	---	-3	-3	-22	-36	-38	-38	-39	-41	-42	-44	-102	-306
2. Excise tax relief for sound pension funding	yba 12/31/01	---	-2	-3	-3	-3	-3	-3	-3	-3	-3	-3	-14	-29
3. Notice of significant reduction in plan benefit accruals	pateo/a DOE	Negligible Revenue Effect												
4. Repeal 100% of compensation limit for multiemployer plans	yba 12/31/01	---	-2	-4	-4	-4	-4	-5	-5	-5	-5	-5	-18	-43
5. Modification of section 415 aggregation rules for multiemployer plans	tyba 12/31/01	---	-1	-1	-1	-1	-1	-1	-1	-1	-1	-1	-4	-8
6. Investment of employee contributions in 401(k) plans	aiii TRA'97	Negligible Revenue Effect												
7. Prohibited allocations of stock in an ESOP S corporation	[8]	---	4	6	7	8	8	9	10	10	10	11	34	84
8. Automatic rollovers of certain mandatory distributions	dma 12/31/01	---	-2	-12	-22	-29	-30	-32	-33	-33	-34	-34	-96	-262
9. Clarification of treatment of contributions to multiemployer plans	yea DOE	---	---	-11	-19	-32	-38	-35	-30	-26	-19	-14	-100	-224
Total of Provisions for Strengthening Pension Security and Enforcement		---	-6	-28	-64	-97	-106	-105	-101	-99	-94	-90	-300	-788

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
Provisions for Reducing Regulatory Burdens														
1. Modification of timing of plan valuations	pyba 12/31/01						Negligible Revenue Effect							
2. ESOP dividends may be reinvested without loss of dividend deduction (25% in 2002 through 2004, 50% in 2005 through 2007, 75% in 2008 through 2010, and 100% in 2011 and thereafter)	tyba 12/31/01	---	-5	-12	-15	-24	-33	-34	-45	-56	-58	-70	-89	-352
3. Repeal transition rule relating to certain highly compensated employees	pyba 12/31/01	---	-2	-3	-3	-3	-3	-4	-4	-4	-4	-5	-14	-34
4. Employees of tax-exempt entities [9]	DOE						Negligible Revenue Effect							
5. Treatment of employer-provided retirement advice	yba 12/31/01						Negligible Revenue Effect							
6. Pension plan reporting simplification [9]	1/1/02						Negligible Revenue Effect							
7. Improvement to Employee Plans Compliance Resolution System [9]	DOE						Negligible Revenue Effect							
8. Repeal of multiple use test	yba 12/31/01						Considered in Other Provisions							
9. Flexibility in nondiscrimination, coverage, and line of business rules [9]	DOE						Negligible Revenue Effect							
10. Extension to all governmental plans of moratorium on application of certain nondiscrimination rules applicable to State and local government plans	yba 12/31/01						Negligible Revenue Effect							
Total of Provisions for Reducing Regulatory Burdens		---	-7	-15	-18	-27	-36	-38	-49	-60	-62	-75	-103	-386
ERISA Provisions														
1. Missing plan participants [6]	[10]	---	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	-1
2. Reduce PBGC premium for new plans of small employers [6]	pea 12/31/01	---	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	-2	-4
3. Phase-in of additional PBGC premium for new plans; include additional variable premium relief for small employers [6]	pea 12/31/01	---	---	-9	-9	-9	-9	-9	-9	-9	-9	-9	-35	-80
4. Authorization for PBGC to pay interest on premium overpayment refunds [6]	iafpbnet DOE	---	-3	-3	-3	-3	-3	-3	-3	-3	-3	-3	-15	-30
5. Rules for substantial owner benefits in terminated plans [6]	noitta 12/31/01	---	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	[3]	-2	-3
Total of ERISA Provisions		---	-3	-13	-13	-13	-13	-13	-13	-13	-13	-13	-54	-118
Miscellaneous Provision - Allow electing Alaska Native Settlement Trusts to tax income to the Trust not the beneficiaries [11]	[12]	---	-4	-4	-3	-3	-3	-3	-3	-4	-4	-4	-17	-35
Total of Pension and IRA Provisions		**---**	**-1,513**	**-3,249**	**-3,416**	**-3,709**	**-4,145**	**-4,016**	**-3,814**	**-4,395**	**-5,480**	**-6,518**	**-16,031**	**-40,250**
AMT Relief - Increase Exemption by $2,000 (Single) and $4,000 (Joint) in 2001 through 2006; Sunset 12/31/06	**tyba 12/31/00**	**-157**	**-2,170**	**-3,161**	**-4,120**	**-6,024**	**-8,743**	**-6,125**	**---**	**---**	**---**	**---**	**-24,375**	**-30,500**
Modification to Corporate Estimated Tax Requirements	**DOE**	**-23,045**	**23,045**	**---**	**-6,606**	**6,606**	**---**	**---**	**---**	**---**	**---**	**---**	**---**	**---**

Provision	Effective	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
Expansion of Authority to Postpone Certain Tax Deadlines Due to Disaster	doa DOE	---	[3]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[13]	[14]
NET TOTAL [15] [16]		-33,144	-64,435	-84,926	-96,802	-111,281	-130,812	-146,976	-156,045	-162,926	-173,255	-186,596	-521,403	-1,347,177

Joint Committee on Taxation

NOTE: Details may not add to totals due to rounding.

Legend for "Effective" column:

aiii TRA'97 = as if included in the Taxpayer Relief Act of 1997
bia = bonds issued after
cba = courses beginning after
cf = contributions for
cpoii = contributions paid or incurred in
bia = bonds issued after
da = distributions after
dda = decedents dying after
doa = disasters occurring after

dma = distributions made after
DOE = date of enactment
gma = gifts made after
iafpbnet = interest accruing for periods beginning not earlier than
ipa = interest paid after
noitta = notice of intent to terminate after
pateo/a = plan amendments taking effect on or after
pea = plans established after

pyba = plan years beginning after
rma = requests made after
ta = transfers after
tdapma = transfers, distributions, and payments made after
tyba = taxable years beginning after
tyea = taxable years ending after
yba = years beginning after
yea = years ending after

[1] The estimates presented in this table include the effects of certain behavioral responses to the tax proposals, including shifts between nontaxable and taxable sources of income, changes in amounts of charitable giving, and changes in the timing of realization of some sources of income. While the estimates do not include the effects of these proposals on economic growth, the proposals are likely to result in modest increases in growth of the economy during the 10-year budget estimating period. The largest component of the proposals, the marginal rate cuts, will provide incentives for more work, investment, and savings.
[2] Estimate assumes that any constitutional challenge based on the use of Federal Case registry data would not be successful.
[3] Loss of less than $500,000.
[4] Provision includes interaction with other provisions in Provisions for Expanding Coverage.
[5] Provision includes interaction with the Individual Retirement Arrangement Provisions.
[6] Estimate provided by the Congressional Budget Office.
[7] Effective for costs paid or incurred in taxable years beginning after December 31, 2001, with respect to qualified employer plans established after such date.
[8] Generally effective with respect to years beginning after December 31, 2002. In the case of an ESOP established after July 11, 2000, or an ESOP established on or before such date if the employer maintaining the plan was not an S corporation on such date, the proposal would be effective with respect to plan years ending after July 11, 2000.
[9] Directs the Secretary of the Treasury to modify rules through regulations.
[10] Effective for distributions from terminating plans that occur after the PBGC has adopted final regulations implementing provision.
[11] Special Federal income tax rules would apply if the Trust makes an election for its first taxable year ending after the date of enactment.
[12] Effective for taxable years of electing Settlement Trusts ending after the date of enactment, and to contributions made to such trust made after the date of enactment.
[13] Loss of less than $1 million.
[14] Loss of less than $5 million.
[15] Includes the following effect on fiscal year outlays (millions):

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011	2001-06	2001-11
outlays (millions)	---	7,272	8,777	9,432	10,823	10,912	10,979	11,563	12,171	12,765	13,396	47,216	108,090

[16]

	2001	2002	2003	2004	2005	2006	2007	2008	2009	2010	2011
Taxpayers affected by the AMT: Present Law (millions of taxpayers)	1.5	3.5	4.3	5.6	7.1	8.7	10.5	12.8	14.9	17.5	20.7
Taxpayers affected by the AMT: Proposal (millions of taxpayers)	1.3	2.7	3.3	4.2	5.5	9.2	15.5	27.2	30.8	34.9	39.6