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RETIREMENT SAVINGS AND SECURITY ACT OF 2005

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Section by Section Explanation

TITLE I – INCREASING RETIREMENT SAVINGS AND SECURITY

AUTOMATIC ENROLLMENT

SECTION 101 OF THE BILL

Present law

Automatic contribution arrangements (also know as negative election arrangements) are elective contribution plans (such as section 401(k) plans, section 403(b) plans, and section 457(b) plans) where the employee's compensation is reduced by a fixed percentage and that amount is contributed to the plan unless the employee specifically elects not to make a contribution of that amount. The Internal Revenue Service has confirmed that contributions under these automatic contribution arrangements are elective contributions, provided that the employee receives a notice explaining his or her rights to have no compensation reduction and, after receiving the notice, the employee has a reasonable period of time in which to elect to receive the cash in lieu of having an employer contribution made to the plan.

ERISA imposes certain duties on plan fiduciaries with respect to retirement plan investments. However, where a participant exercises control over retirement plan assets, a fiduciary is not liable for any loss that results from the participant's exercise of control (*see* ERISA section 404(c)). In the case of an automatic contribution arrangement, it is not entirely clear how these rules would be applied in all instances, *e.g.*, where the participant has not made an affirmative election as to investment options.

In addition, there is some uncertainty as to whether State law would permit automatic contribution arrangements in all instances or whether any inconsistent State law would be preempted.

Reasons for change

Employers that have adopted automatic contribution arrangements have been able to achieve a high level of employee participation. The simple "opt-out" mechanism (as opposed to "opt-in") - - whereby an employee is treated as having elected to contribute a certain amount unless the employee specifically elects otherwise - - has a powerful effect on participation, even though all employees continue to have the right not to participate or to stop participating at any time.

To date, large numbers of employers have not implemented automatic contribution arrangements, at least in part because of the costs associated with implementing such an arrangement and the uncertainty surrounding the application of ERISA and State law. Without resolution of the uncertainty and absent targeted incentives encouraging employers to offer automatic contribution arrangements, employers are less likely to offer these powerful savings tools to their employees.

Proposal

In general. Under the proposal, a section 401(k) arrangement would be treated as meeting the ADP nondiscrimination test if the arrangement constitutes an automatic contribution trust ("ACT"). An ACT is an arrangement under which (1) eligible employees automatically contribute the applicable percentage of compensation (or a higher percentage) until the employee elects otherwise and (2) specific employer contribution, vesting, and notice requirements (described below) are satisfied. The applicable percentage would begin at 3% and would increase by one percentage point on an annual basis until the percentage reaches 10%. Alternatively, the employer (or the plan administrator on behalf of the employer) may elect, in lieu of having the applicable percentage increase on a plan year basis, to have the applicable percentage increase after each annual (or less frequent) increase in an employee's compensation. It is intended that the Secretary shall prescribe rules with respect to what constitutes an annual (or less frequent) increase in compensation and how to apply this rule to a diverse workforce with different dates on which compensation increases.

Employees to whom the ACT applies. In order to qualify for the nondiscrimination safe harbor, a plan is only required to apply the ACT rules to newly-eligible employees. A plan is not required to apply the same rules to employees eligible to participate in the plan immediately prior to the effective date of the ACT. On the other hand, current law permits the automatic contribution arrangement to be applied in the same or different form to employees previously eligible to participate in the plan.

Contribution requirement. Under the contribution requirement, ACTs must provide either (1) matching contributions equal to 50% of each nonhighly compensated employee's elective contributions to the extent that such elective contributions do not exceed 6% of compensation, or (2) at least a 2% nonelective contribution on behalf of each nonhighly compensated employee eligible under the arrangement. This requirement is subject to rules similar to those applicable to the existing section 401(k) safe harbor, including prohibitions on (a) using Social Security integration (or permitted disparity) to satisfy the contribution requirements, (b) favoring any highly compensated over any nonhighly compensated employee with respect to the rate of matching contributions, and (c) the rate of matching contributions increasing as an employee's rate of elective contributions increases. The proposal also makes applicable to ACTs the rules under the existing section 401(k) safe harbor that permit (1) the contribution rule to be satisfied by contributions under other plans of the employer, and (2) the use of an alternative matching formula that is at least as generous at every level of elective contribution.

Vesting requirement. Under the vesting rule, the matching or nonelective contribution used to meet the above contribution requirement must be 100% vested for all eligible employees with at least two years of service.

Notice requirement. Employees must be notified regarding their right to elect to decline to participate in the ACT and regarding how their contributions will be invested in the absence of a specific investment election. After such notice, employees must be provided a reasonable amount of time prior to the first automatic elective deferral to make a different election regarding their contribution or investment. Additionally, an annual notice of an employee's rights and obligations under the ACT must be provided. The existing 401(k) safe harbor notice requirements regarding accuracy, comprehensiveness, and understandability apply to these notices.

Matching contribution safe harbor. ACTs with an ACT matching contribution feature will be treated as meeting the section 401(m) ACP nondiscrimination test. This exemption from the ACP test would also apply in the case of a section 403(b) arrangement that constitutes an ACT.

Exemption from top-heavy rules. ACTs are excluded from the definition of top-heavy plans under the same rule applicable to the existing section 401(k) safe harbor.

Base pay and rate of pay. Under the proposal, the Secretary of the Treasury is directed to facilitate the use of base pay or rate of pay in connection with satisfying the ACT requirements, the existing 401(k) safe harbor, and the defined benefit plan nondiscrimination safe harbor. Many plans across the country use base pay or rate of pay for purposes of determining benefits; this simplifies plan administration and facilitates budgeting. Under present law, those employers have great difficulty using the existing design-based nondiscrimination safe harbors - - the section 401(k) safe harbor and the defined benefit plan nondiscrimination safe harbor. The problem is that those safe harbors require plans to use a definition of compensation permitted under Code section 414(s). Where the amount of overtime that a company pays fluctuates from year to year, it is generally not possible to know until after the plan year whether a plan's base pay or rate of pay satisfies section 414(s). Determining after year-end that a plan does not meet a design-based safe harbor can create significant problems; accordingly, companies that use base pay or rate of pay in their plans generally cannot use either of the existing designed-based nondiscrimination safe harbors.

Similarly, such companies would not be able to use the ACT safe harbor. To address this problem, the proposal directs the Secretary by December 31, 2006, to modify the regulations under section 414(s) to facilitate the use of the ACT safe harbor, as well as the existing safe harbors, by plans that use base pay or rate of pay. This facilitation shall permit increased flexibility in satisfying section 414(s) where the amount of overtime paid by the plan sponsor varies significantly from year to year.

Payroll-based plans. The proposal would also direct the Secretary by December 31, 2005, to permit the ACT safe harbor to apply on a payroll-by-payroll basis under rules similar to those currently applicable to the section 401(k) safe harbor.

Section 403(b) plans. The proposal codifies in the statute the existing rule permitting section 403(b) arrangements to adopt the current-law section 401(m)(11) safe harbor.

Default investments. The proposal provides guidance on appropriate default investments in defined contribution plans, including automatic enrollment plans (without regard to whether they meet the ACT safe harbor requirements). If a default investment is made in accordance with this provision, the plan fiduciary shall not have any fiduciary liability with respect to the type of investment chosen.

Specifically, the provision approves the following types of default investments: diversified investment options that vary the emphasis and exposure among various asset classes as the participant approaches a target retirement date, such as model portfolios, life-cycle funds, retirement target date funds, and other similar investment options. In addition, the provision is intended to permit combinations of options to be treated as an approved default investment; for example, a plan could designate a combination of an equity option and a fixed income option as a combined default investment.

The provision also directs the Secretary of Labor to issue regulations, within six months of enactment and from time to time as appropriate thereafter, identifying other types of diversified default investments designed to provide long-term appreciation for which there would be no fiduciary liability. Such investments could include balanced funds or portfolios and other options that provide an appropriate mix of different asset classes.

Under the proposal, a plan fiduciary would still be required to choose a prudent default investment option. For example, a plan fiduciary would still have liability if the life-cycle fund chosen were clearly poorly managed and consistently underperformed the market.

The fiduciary protection described above would only apply if participants are provided timely notice of contributions and investments that will be made on their behalf if they do not make an affirmative election.

Preemption. The proposal clarifies that ERISA preempts any state laws to the extent that such laws would directly or indirectly prohibit or restrict automatic contribution arrangements (without regard to whether they meet the ACT safe harbor requirements).

Safeguard. The proposal also creates a safeguard regime under which participants who made automatic contributions (without regard to whether they are made under an ACT safe harbor plan) can, within the first three months after enrollment, elect to receive a corrective distribution from the plan of up to $500 (plus earnings). This safeguard addresses the situation where, for example, an employee did not initially realize that automatic contributions were being made on his or her behalf.

Election and notices. Under all components of the proposal described above, notices to participants and elections by participants may be provided through the use of paperless technologies to the extent that (1) such technologies are reasonably accessible to participants, and (2) such use is consistent with guidance prescribed by the Secretary of the Treasury or the Secretary of Labor (as applicable).

Sense of the Congress. Under the proposal, it would be the sense of Congress that automatic contribution arrangements (including automatic increases) should be considered broadly by employers, including employers not subject to ERISA. There should be an ongoing dialogue to promote such arrangements and to address obstacles preventing employers from adopting such arrangements.

Effective date. The proposal would apply to years beginning after December 31, 2005 (except that the provision clarifying that section 403(b) plans may use the existing section 401(m)(11) safe harbor would be a clarification of existing law and thus would apply to years beginning after December 31, 1998).

EXPANSION OF THE SAVER'S CREDIT

SECTION 102 OF THE BILL

Present law

The Economic Growth and Tax Relief Reconciliation Act of 2001 ("EGTRRA") established a new nonrefundable tax credit for certain individuals for elective deferrals to workplace retirement plans and contributions to IRAs. Under this "Saver's Credit," the maximum contribution eligible for the credit is $2,000 and the credit rate depends upon the adjusted gross income ("AGI") of the taxpayer. Only joint returns with AGI of $50,000 or less, head of household returns with AGI of $37,500 of less, and single returns with AGI of $25,000 or less are eligible for the credit. The credit is in addition to any deduction or exclusion that would otherwise apply with respect to the contribution. 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 rates based on AGI are as follows:

Joint Filers	*Heads of Households*	*All Other Filers*	*Credit Rate*
$0-$30,000	$0-$22,500	$0-15,000	50 percent
$30,000-$32,500	$22,500-$24,375	$15,000-$16,250	20 percent
$32,500-$50,000	$24,375-$37,500	$16,250-$25,000	10 percent
over $50,000	Over $37,500	Over $25,000	0 percent

Under EGTRRA, the Saver's Credit is only available for five years, from 2002 through 2006.

Reasons for change

The Saver's Credit has already proven itself to be a powerful incentive for low and moderate-income families to save for retirement. Therefore, there is no reason not to extend it to the end of the EGTRRA sunset period. Correspondingly, the original income brackets were not indexed for inflation, so that over time, the Saver's Credit would shrink in scope and effect; this needs to be corrected.

Also, the current-law income bracket eligible for a 20% credit is extremely narrow. This strong incentive should be available to a broader group.

Proposal

Under the proposal, income eligibility for a 20% credit would be significantly expanded so that joint returns with AGI between $30,000 and $40,000, head of household returns with AGI between $22,500 and $30,000, and single returns with AGI between $15,000 and $20,000 would be eligible. The revised credit rates based on AGI would be as follows:

Joint Filers	*Heads of Households*	*All Other Filers*	*Credit Rate*
$0-$30,000	$0-$22,500	$0-15,000	50 percent
$30,000-$40,000	$22,500-$30,000	$15,000-$20,000	20 percent
$40,000-$50,000	$30,000-$37,500	$20,000-$25,000	10 percent
Over $50,000	Over $37,500	Over $25,000	0 percent

In addition, these income brackets would, for years beginning after December 31, 2008, be adjusted to take into account changes in the cost-of-living. After each adjustment, each income reference would be rounded to the nearest multiple of $1,000.

Under the proposal, the Saver's Credit would also be extended through 2010, so that it sunsets at the same time that the EGTRRA provisions generally sunset.

The proposal would apply to taxable years beginning after December 31, 2006.

ENHANCING PORTABILITY – FSA TRANSFERS

SECTION 103 OF THE BILL

Present law

A flexible spending arrangement ("FSA") is generally an arrangement under which an employee has a choice between cash compensation and reimbursement for qualified benefits, such as health benefits. Currently, if an FSA meets the cafeteria plan requirements of section 125, the cash compensation that was available but not elected is not included in the employee's gross income or wages for tax purposes merely because it was available. In the case of employees who elect qualified benefits, section 125 contains a "use it or lose it" provision that prevents elected amounts from being carried forward to future periods of time or used for other purposes if the amounts are not used for the elected qualified benefit by the date that is 2 ½ months after the end of the year.

Reasons for change

Allowing a limited amount of health FSA amounts to be contributed to a retirement arrangement would encourage increased retirement savings by creating an additional source of contributions. At the same time, it would improve the efficiency of FSAs by removing incentives for employees to use those benefits unnecessarily when the employees would otherwise lose them.

Proposal

Under the proposal, an employer's health FSA could permit up to $500 in amounts available but not used for medical expenses to be contributed to a section 401(k) plan, section 403(b) plan, governmental section 457(b) plan, or IRA. Any such contributions to a retirement plan or IRA would be subject to the rules otherwise applicable to contributions (*e.g.,* contribution limits, discrimination tests, and income tax treatment applicable to contributions.) For example, a contribution to an IRA would be includible in the employee's income and, to the extent otherwise permitted, deductible as an IRA contribution.

The Secretary of the Treasury shall prescribe such rules as are appropriate to facilitate the contributions permitted by the proposal. Such rules may include flexibility with respect to the year to which the contributions relate and special testing treatment to avoid burdensome administrative issues.

The proposal would apply to years beginning after December 31, 2005.

DIRECT PAYMENTS OF TAX REFUNDS TO IRAs

SECTION 104 OF THE BILL

Present law

The Secretary of the Treasury has the authority under current law to permit an individual to direct that all or a portion ("split refunds") of his or her tax refund be deposited directly in an IRA. However, the Secretary has not exercised that authority and, accordingly, such direct payments are not currently permitted.

Reasons for change

If the law can make it easier to save for retirement, there will be more retirement savings and, accordingly, increased retirement security. Tax refunds are often the largest non-paycheck payments that individuals receive; for many individuals living on their paychecks, this supplemental source of funds could in some years be saved for retirement. Direct payment opportunities (such as split refunds) will make it easier to do so and thus more likely that such savings occur.

Proposal

Within one year after the date of enactment, the Secretary of the Treasury would be directed to prescribe rules permitting individuals to elect to have all or a portion of their tax refund paid directly to an IRA (either a traditional deductible IRA or a Roth IRA). The Secretary would be authorized to prescribe rules that are necessary or appropriate in the efficient implementation of such direct payments, including rules regarding minimum payments and the taxable year on account of which the payment is made. The proposal also clarifies that if a tax return is filed by the due date for the return (without regard to extensions), the payment of any refund with respect to that return to an IRA may relate to the year to which the refund relates.

The proposal applies to tax returns filed after final rules are issued by the Secretary.

TITLE II – FACILITATING GUARANTEED INCOME FOR LIFE

QUALIFIED ANNUITIZATION INCENTIVE

SECTION 201 OF THE BILL

Present law

Under current law, there are numerous tax incentives with respect to retirement savings, including favorable tax treatment of qualified retirement plans, section 403(b) plans, governmental section 457(b) plans, and IRAs. These incentives play a vital role in encouraging employees to save for retirement and in promoting the adoption of retirement plans by employers.

Generally, amounts distributed from retirement arrangements are fully included in the recipient's income (except to the extent that the distribution consists of a return of an individual's after-tax contributions or consists of a qualified distribution from a Roth IRA or, after 2005, a qualified Roth contribution program under section 402A).

Reasons for change

As noted above, the current-law tax incentives are generally focused on encouraging retirement savings. With increases in longevity and the shift from defined benefit plans to defined contribution plans, however, retirees face a new challenge. Not only must they save enough for retirement, they must also learn how to manage their savings during a retirement period of uncertain length. This is at best an extremely difficult task for a retiree on his or her own. If retirees draw down their retirement savings over their life expectancy, half of them will outlive their retirement savings (since by definition half the population lives beyond their actuarially determined life expectancy). If, on the other hand, retirees draw down their retirement savings based on the expectation that they will outlive their life expectancy, they will be withdrawing significantly less money and thus will be forced to materially adjust their standard of living for all or part of their retirement. For those who do not outlive their life expectancy, this lower standard of living is unnecessary.

Life annuities help retirees manage their retirement savings during retirement. By providing guaranteed income for life, life annuities ensure that retirees do not outlive their retirement savings. And by use of the insurer's mortality risk pool, a material reduction in the level of payments becomes unnecessary.

One of the keys to increasing the purchase of life annuities by retirees is education. If retirees understand the longevity risk and the beneficial effects of life annuities, they will see the value of receiving a portion of their retirement savings in the form of a life annuity.

To stimulate the education process, a tax incentive is needed. The tax incentive need not be large enough to change the economics of the retiree's decision-making process regarding whether to purchase an annuity. But the tax incentive needs to be large enough to stimulate the retiree to learn more about life annuities and their non-tax advantages.

Proposal

Under the proposal, a portion of any otherwise taxable distribution received from a qualified defined contribution plan, a section 403(b) plan, a governmental section 457(b) plan, or an IRA in the form of life (or joint and survivor life) annuity payments would be excludable from gross income. The amount that would be excludable from income would be 10% of otherwise taxable annuity payments up to $21,000 (indexed) per year (*i.e.,* a maximum annual excludable amount of $2,100 (indexed)). If a distribution begins as a life annuity, but is subsequently converted to a non-life annuity form, any prior tax benefits under the proposed rule would be recaptured (with interest).

The life (or joint and survivor life) annuity payments must be made under a commercial annuity contract. Such payments may be made directly to the participant or may be made to the plan or IRA if the plan or IRA pays the participant within a reasonable period after receipt by the plan or IRA.

The proposal would apply to distributions made after December 31, 2005.

NONQUALIFIED ANNUITIZATION INCENTIVE

SECTION 202 OF THE BILL

Present law

Under current law, contributions to nonqualified annuity contracts are purchased with after tax dollars and are not deductible, but earnings and appreciation under such annuity contracts generally are not includible in income until paid or made available. Current law contains a number of special rules, such as a 10% penalty tax on certain withdrawals before 59½, designed to ensure that nonqualified annuities are used for retirement savings. Amounts distributed from such annuities are fully included in the recipient's income except to the extent that the distribution consists of a return of contributions.

Reasons for change

Today's retirement security challenges are particularly acute for the tens of millions of Americans not covered by an employer-sponsored retirement plan. Fifty percent of Americans do not have access to employer provided retirement savings. In addition, even those covered by such a plan may be receiving benefits that are not sufficient to provide retirement security. Accordingly, there is a great need for individual arrangements that can provide retirement security. Nonqualified annuities provide such an individual arrangement that is available to everyone without regard to whether their employer maintains a retirement plan.

Increases in longevity make nonqualified annuities even more important as a solution to the retirement challenge. Approximately one out of six 65 year old men and one out of three 65 year old women are expected to live into their 90's. Because of increases in longevity, individuals not only have to save enough for retirement, they must also learn how to manage their savings during a retirement period of uncertain length. Managing longevity and market risk is at best an extremely difficult task for a retiree on his or her own. If retirees draw down their retirement savings over their life expectancy, half of them will outlive their retirement savings (since by definition half the population lives beyond their actuarially determined life expectancy). Life annuities are paid out on a life *contingent* basis, meaning that payments will continue regardless of how long the annuity holder lives, as distinct from life *expectancy* which ends at a certain attained age. The transfer of longevity and market risk to the insurance company gives rise to the insurable risk in a life contingent annuity contract.

Life annuities help retirees manage their retirement savings risk during retirement. By providing guaranteed income for life, life annuities ensure that retirees do not outlive their retirement savings. And by use of the insurer's mortality risk pool, a material reduction in the level of payments becomes unnecessary.

Nonqualified annuities purchased outside the employer setting and with after tax dollars are often purchased by those without access to qualified plan retirement savings, such as farmers, women, seasonal workers, or those who own a family business. Accordingly, the benefits of pre-tax accumulation and employer education and administrative overhead are not present for these non-qualified annuity purchases. In order to mimic the guaranteed payment stream of traditional pension plans, a meaningful incentive is necessary to incent lifetime payout for those who otherwise may not have access to a guaranteed source of retirement income. Absent a meaningful incentive, individuals entering retirement may fail to consider the advantages of protecting themselves against longevity risk by electing life a lifetime payment stream.

Proposal

In general, under the proposal, a portion of any otherwise taxable distribution received from a nonqualified annuity in the form of life (or joint and survivor life) annuity payments would be excludable from gross income. The amount that would be excluded from income would be 50% of otherwise taxable annuity payments, subject to a cap on the excludable amount of $20,000 (indexed) per year. If a distribution begins as a life annuity, but is subsequently converted to a non-life annuity form, any prior tax benefits under the proposed rule would be recaptured (with interest). Under the proposal, rules similar to those for life annuity payments from annuity contracts would also apply to payments of life insurance death benefit proceeds made in the form of a series of lifetime payments over the life of the beneficiary of the life insurance contract or the joint and survivor lives of the beneficiaries.

The proposal would apply to amounts received in calendar years beginning after the date of enactment.

FACILITATING ANNUITIZATION AND PORTABILTY

SECTION 203 OF THE BILL

Present law

Under current law, individual account plans generally do not offer specific IRAs as available to receive rollovers of amounts payable under the plan. Instead, plan participants generally must find their own IRAs. One reason that plans are structured in this way is that the designation of a specific IRA is generally viewed as a fiduciary act. Employers are hesitant to expose themselves to fiduciary liability in this context.

Because of similar fiduciary concerns, many plans either do not offer specific annuity contracts or do not offer annuities at all. In fact, the fiduciary concerns are even more acute with respect to annuities because of confusion regarding the application of the safest available annuity standard under Department of Labor ("DOL") Interpretive Bulletin 95-1. That Interpretive Bulletin arose in the context of terminating defined benefit plans where an employer could benefit directly from choosing a cheaper, less safe annuity contract to provide benefits to participants. If the annuity contract costs less, the employer's reversion from the terminated defined benefit plan is greater. In that context, the Interpretive Bulletin correctly required that fiduciaries perform a rigorous examination to find the safest available annuity.

In the context of individual account plans, where an annuity contract is available to participants as an option and the employer's financial interest is not different from the participants' interest with respect to the selection of an annuity contract, the fiduciary analysis is markedly different. However, there has been confusion in the marketplace in this regard; some employers and fiduciaries have been concerned that the same safest available annuity standard would apply in this context.

In other areas of the law, the DOL has made it clear that an employer can make certain arrangements available without endorsing them and thus without fiduciary liability. For example, under DOL Regulation § 2510.3-2(d) and DOL Interpretive Bulletin 99-1, a payroll deduction IRA that is made available to an employer's employees but that is not endorsed by the employer and satisfies specified criteria is not treated as a pension plan of the employer under ERISA. Thus, such arrangements are not subject to the ERISA fiduciary rules. DOL Regulation § 2510.3-2(f) provides similar treatment of elective-contribution-only section 403(b) plans under similar conditions.

Reasons for change

It is very important that plans make specific annuity contracts and IRAs available as distribution options for departing participants. Under current practices, individuals who want to receive their benefits in the form of a life annuity generally must find an annuity in the individual market at individual rates (*e.g.*, under an individual retirement annuity), which are more expensive. Often, the result is that individuals do not choose an annuity that they very much need. If plans can offer specific annuities, the annuities can be less expensive which will lead to more employee interest. Increased employee interest will, in turn, result in more plans offering annuities.

In the IRA context, some plans are beginning to offer specific IRAs as available to receive a rollover. They may be doing so because the broad array of investments available under a particular IRA causes the plan fiduciaries to be reasonably confident that the fiduciary risk, if any, is very low. But other plans are not doing this. Employees in those plans may let inertia dictate their actions; in the absence of a readily available IRA to take a rollover distribution, many terminating employees may elect a lump sum distribution and not roll it over.

Proposal

Under the proposal the Secretary of Labor is directed to prescribe, within 12 months of the date of enactment, regulations clarifying that, if certain conditions are satisfied with respect to an individual account plan, employers (or other plan fiduciaries) have no liability attributable to offering one or more specific IRAs and/or annuity contracts to departing participants. These regulations would have two components. Under the first component, if the regulatory conditions are satisfied, the employer (or other fiduciary) would not be treated as having endorsed the IRA and/or annuity contract. Thus, the designation of the IRA and/or annuity contract would not be a fiduciary act. The regulations would provide simple conditions that could generally be applied based on clear mechanical criteria, rather than based on facts and circumstances considerations. Such conditions would (1) clarify that the provision is completely optional for the participant (i.e., no transfer, distribution, or investment would be made except pursuant to a participant's election), (2) require that the participant be permitted to choose other IRAs or annuity contracts not specified by the plan, (3) require disclaimer language making it clear that the plan fiduciary is not endorsing the specified IRA and/or annuity contract, (4) prescribe threshold qualifications that would have to be met by the specified IRA, annuity contract, and trustee or issuer of the IRA or annuity contract, (5) require that fees under the IRA or annuity contract be reasonable, (6) provide guidance on the types of investments that could be made available under the specified IRA or annuity contract, and (7) provide guidance on the participant's ability to choose and change investments.

The second component of the regulations would address circumstances where the employer has directly or indirectly endorsed the IRA and/or annuity contract as an option available to participants under the plan. This component of the regulations would clarify that under such circumstances, the employer (or other plan fiduciary) must act in accordance with the general prudence standards of ERISA section 404(a). In this regard, the regulations would also clarify that these standards are similar to the standards applicable to a plan fiduciary in choosing investment options to be made available to participants under an individual account plan. Although distribution options (like IRAs or annuity contract) may require a plan fiduciary to examine different factors in fulfilling its fiduciary duty, the level of scrutiny and the fiduciary framework is intended to be the same as is applicable in choosing investment options to be made available. It is not intended that there only be a single "most prudent" IRA or safest available annuity contract; numerous IRAs and/or annuity contracts may constitute prudent options.

The regulations would address both types of IRAs, *i.e.*, individual retirement accounts and individual retirement annuities. Also, although the regulations would provide general fiduciary relief with respect to specification of one or more IRAs and/or annuity contracts, such specification would remain subject to the prohibited transaction rules. The regulations would also make it clear that any applicable fiduciary duties cease to apply when assets have been transferred to an IRA or annuity contract; at that point, the assets cease to be plan assets.

The proposal would take effect on the date of enactment.

CORRECTION TO 1996 ACT CONFORMING CHANGE

SECTION 204 OF THE BILL

Present law

Section 1401 of the Small Business Job Protection Act of 1996 (the "96 Act") repealed special averaging rules for lump sum distributions from qualified retirement plans. In doing so, the Act eliminated the definition of a "lump sum distribution" that had been included in former Code section 402(d)(4). That definition, in turn, served as a cross-reference for the definition of a lump sum distribution for purposes of the net unrealized appreciation ("NUA") rules of Code section 402(e)(4).

Because it was still necessary following the 96 Act changes to define a lump sum distribution for purposes of the NUA rules, Congress included a conforming change in section 1401 of the 96 Act that added a definition of a lump sum distribution to the NUA rules in Code section 402(e)(4)(D) (replacing the former cross-reference to former Code section 402(d)(4)). That definition is identical to the definition in former Code section 402(d)(4) except that it omitted the following sentence, "A distribution of an annuity contract from a trust or annuity referred to in the first sentence of this subparagraph shall be treated as a lump sum distribution."

The reason for the omission in the conforming amendment is unclear, and the legislative history does not address it. The drafters may have believed that the omitted language was no longer relevant because the definition of a lump sum distribution after the 96 Act related only to NUA, which applies only to employer securities and not to a distribution from an annuity contract.

Reasons for change

While it is true that NUA cannot apply to a distribution from an annuity contract, the omitted language is still relevant. The reason for this is that an annuity contract historically could be part of a lump sum distribution. *See, e.g.*, former Code section 402(d)(2)(A). Thus, for example, prior to the 96 Act, if an employee were to receive a $200,000 distribution of his or her entire account balance – $100,000 in the form of employer securities and $100,000 in an annuity contract – the distribution would be considered a lump sum distribution, and the employee could receive NUA treatment, if applicable, with respect to the employer securities (but would not receive NUA treatment with respect to the distribution of the annuity contract). Today, under the same example, the distribution arguably may not be a lump sum distribution because part of the distribution is an annuity contract. This would mean that an individual cannot be treated as receiving a lump sum distribution for purposes of the NUA rules if any part of the recipient's distribution is in the form of an annuity contract.

If Congress had intended such a change in the law, it would have been discussed in legislative history. Moreover, the fact that the 96 Act amendment is labeled a conforming amendment indicates that there was no intent to make a substantive policy change in the definition. This error should be corrected by reinserting the omitted language in the definition of a lump sum distribution in current Code section 402(e)(4)(D).

Proposal

Under the proposal, the language omitted from the 96 Act conforming amendment - - providing that a distribution of an annuity contract from a retirement plan may be part or all of a lump sum distribution - - would be reinserted into Code section 402(e)(4)(D).

TITLE III – SIMPLIFICATION AND EQUITY

CLARIFICATION OF TREATMENT OF INDIAN TRIBAL GOVERNMENTS

SECTION 301 OF THE BILL

Present law

Section 414(d) of the Internal Revenue Code provides that the term "governmental plan" means a plan established and maintained for its employees by the government of the United States, by the government of any State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing. The term "governmental plan" also includes any plan to which the Railroad Retirement Act of 1935 or 1937 (the Act) applies and which is financed by contributions under that Act, and any plan of an international organization which is exempt from taxation by reason the International Organizations Immunities Act (59 Stat. 669). Identical language appears in ERISA section 3(32).

Section 1505 of the Taxpayer Relief Act of 1997 ("TRA '97") generally provides that the nondiscrimination rules do not apply to State and local governmental plans. In particular, TRA '97 amended the Code to provide that sections 401(a)(3), 401(a)(4), and 401(a)(26) shall not apply to such plans. TRA '97 also amended section 401(k) to provide that State and local governmental plans shall be treated as meeting the requirements of section 401(k)(3). In addition, TRA '97 amended section 410(c) of the Code to provide that all governmental plans shall be treated as meeting the requirements of section 410 for purposes of section 401(a). The Treasury Department presently extends the relief afforded to State and local governmental plans to all governmental plans. Section 4(b)(1) of ERISA generally exempts governmental plans from the provisions of ERISA.

The IRS previously issued determination letters that explicitly recognized that retirement plans sponsored by Indian tribal governments were governmental plans. However, on January 5, 2004, in Revenue Procedure 2004-4, the IRS declared that it would no longer issue letter rulings or determination letters on whether or not an Indian tribal government satisfies the requirements of section 414(d). The Service reiterated its no ruling position in Revenue Procedure 2005-4 on January 4, 2005.

Reasons for change

As a governmental employer Indian tribal governments derive no tax benefits from the establishment of a tax-qualified retirement plan. Nor do tribal governments operate with the "profit" motive of a business. It is tribal governments' ultimate responsibility to ensure not private wealth and individual gain, but employment, economic security, and public services for tribal members. In order to do this, tribal governments, as do the federal, state, and other local governments, must attract and retain qualified personnel. To compete with private employers who do not face the added constraint and salary caps of the public budgetary process, however, governments have traditionally countered high private salaries with strong public benefits.

Given the diverse nature of government employment and operations, it has long been clear that governmental employers (as defined in Code section 414(d) and ERISA section 3(32)) would not be able to offer tax qualified retirement programs if they had to be tested under the standard corporate employer rules. Like their state and federal government counterparts, tribal governments have many diverse employment segments, such as a fire department, a police department, a public housing department, a judiciary, an administrative branch, and several enterprises designed to bring revenue into the public fisc. Like their state and federal counterparts, tribal governments could not offer tax-qualified programs tailored to address the different needs of their diverse workforce if they had to be tested under the standard corporate rules. In fact, the traditional early retirement defined benefit plans commonly provided to public safety workers cannot be provided without the governmental plan rules.

Proposal

The proposal would clarify that plans maintained by Indian tribal governments are governmental plans under the Code and ERISA. The proposal would similarly clarify that special rules under the Code and ERISA that only apply to plans maintained by State and local governments apply to Indian tribal governments. Finally, the proposal conforms the law to the Treasury Department's longstanding position by extending the TRA '97 nondiscrimination exemptions applicable to State and local government plans to all governmental plans.

Because this proposal simply clarifies existing and prior law, it applies to any year beginning before, on, or after the date of enactment.

RATIONALIZATION OF TAX RULES FOR CORRECTIVE DISTRIBUTIONS

SECTION 302 OF THE BILL

Present law

Sections 401(k) and 401(m) apply nondiscrimination rules that limit the amounts that may be contributed by or for highly compensated employees ("HCEs") under defined contribution plans. The nondiscrimination rule applicable to elective deferrals under section 401(k) is referred to as the ADP test. The nondiscrimination rule applicable to employer matching contributions and after-tax employee contributions under section 401(m) is referred to as the ACP test. Employers are required to perform the ADP and ACP tests each year to ensure the nondiscrimination rules are not violated. These tests generally must be completed within 2½ months after the close of the plan year (*i.e.*, March 15th for a calendar year plan) to avoid the excise taxes discussed below.

If contributions exceed the amounts permitted under the tests, corrective action must be taken. The primary method of correction is to return the excess contributions and related earnings to the HCEs no later than 12 months after the end of the plan year; for this purpose, related earnings generally must be determined as of a date within seven days of distribution. Excess contributions (and related earnings) that equal $100 or more and that are distributed within 2½ months after the end of the plan year are generally treated as income for the prior taxable year. This often requires the HCE to file an amended income tax return. Excess contributions (and related earnings) that are distributed after the 2½ month period, or that are less than $100, are treated as income for the year in which the distribution is made; however, the employer must pay a 10% excise tax on any excess contributions that are not distributed within the 2½ month period.

For example, assume that an HCE defers $10,000 under a plan and receives matching contributions of $5,000 during the 2005 calendar year plan year. Assume further that in order to correct a violation of the ADP and/or ACP test, the plan must distribute $1,500 (and related earnings) to the HCE. If the plan distributes $1,500 and related earnings to the HCE by March 15, 2006, the HCE must include the distributed amount in his or her gross income for 2005. If the $1,500 (and related earnings) is not distributed until after March 15, 2006, the HCE must include it in his or her gross income for 2006 and the employer must pay an excise tax of $150.

Reasons for Change

The current law March 15th deadline for completing the ADP/ACP tests and corrections in order to avoid excise taxes imposes a significant administrative burden on plan sponsors and their service providers. In the case of small businesses, necessary employee census data may not be available to the plan service provider since the small business accountant likely has not completed the work associated with the entire business. In the case of large and small businesses, the time pressures associated with the March 15 deadline can cause errors and miscommunications; these problems are costly and time-consuming to address. Moreover, the burdens have multiplied in recent years as additional testing issues have required more work to be completed by March 15.

Also, under certain circumstances, determining the allocable earnings for the period between the end of the plan year and the date of distribution creates an additional administrative burden, adding unnecessary complexity and cost given the immaterial amounts involved. Finally, the requirement that certain corrective distributions be includible in income in the prior year is very disruptive for individuals who may have already filed their tax returns.

The administrative costs associated with the March 15th deadline, the earnings calculations, and retroactive income inclusion are unnecessary and should be eliminated.

Proposal

The proposal provides that the excise tax on failure to distribute excess contributions under sections 401(k) and 401(m) would not apply if distribution of such contributions (and related earnings) occurs within six months after the end of the plan year. In addition, only earnings attributable to such excess contributions through the end of the related plan year would need to be calculated and distributed. Finally, to ease the impact on affected plan participants, all corrective distributions would be includible in income in the year distributed.

The proposal would be effective for plan years beginning after December 31, 2005.

FIDUCIARY RULES IN THE CASE OF A CHANGE IN INVESTMENT OPTIONS

SECTION 303 OF THE BILL

Present law

In the case of an individual account plan, it is common for the plan to permit participants to choose how to invest the amounts allocated to their accounts among a menu of investment options offered under the plan. Under current law, the applicable plan fiduciary has the fiduciary duty to designate a prudent menu of investment options. If such a menu is available and the plan meets certain other conditions (including conditions related to disclosures to participants), under ERISA section 404(c), the plan fiduciary has no liability for the investment choices made by participants.

Reasons for proposed change

The proposal would clarify the legal responsibility of plan fiduciaries in situations where the menu of investment options available under a plan changes. It is frequently necessary for a plan fiduciary to change the investment options available under a plan. For example, the fiduciary may determine that certain options are no longer prudent. Or the fiduciary may determine that the plan's service provider, which provides an array of services including investment options, is providing unsatisfactory services and should be replaced. In connection with a change in available investment options, it may be necessary in some cases to transfer participants' assets from a former option to a replacement option. Plans using ERISA section 404(c) will generally offer participants the opportunity to choose how to invest the assets invested in the option being eliminated. However, if the participant fails to make an investment election, the plan must designate a default investment option to receive the transferred funds. The law does not clearly provide the plan fiduciary with a means to protect itself from liability with respect to the default investment.

The lack of clarity regarding the default investment has adverse effects. For example, in many cases, it can cause plan fiduciaries to choose very conservative default investment funds, such as money market funds.

Proposal

Under the proposal, in connection with a change in the available investment options under a plan, the applicable plan fiduciary would not have liability if the plan fiduciary transfers assets from the investment options being eliminated to other prudent options in accordance with the rules set forth below. First, participants must be given reasonable advance notice of the change in the available investment options, including information as to how to elect an alternative investment and how the participant's assets will be invested in the absence of an affirmative election by the participant. Second, if the participant elects an alternative available investment, the plan must transfer the elected amount to that alternative investment and otherwise comply with ERISA section 404(c). Third, if the plan otherwise complies with ERISA section 404(c) and a participant does not make an election, the assets in the participant's account that were invested in the option being eliminated must be transferred, in accordance with the notice given to the participant, to a plan option with reasonably comparable risk and return characteristics. For example, if the plan is replacing an underperforming large cap growth fund with a better large cap growth fund, any amounts in the former would be transferred to the latter in the absence of a different election by a participant.

The notices to participants and the participant elections described above may be provided through the use of paperless technologies to the extent that (1) such technologies are reasonably accessible to participants, and (2) such use is consistent with guidance prescribed by the Secretary of Labor.

The proposal would take effect on the date of enactment.