INVESTMENT COMPANY INSTITUTE

MEMO# 14553

March 19, 2002

PRESIDENT SIGNS INTO LAW H.R. 3090, THE "JOB CREATION AND WORKER ASSISTANCE ACT OF 2002"

[14553] March 19, 2002 TO: TAX MEMBERS No. 12-02 ACCOUNTING/TREASURERS COMMITTEE No. 11-02 TRANSFER AGENT ADVISORY COMMITTEE No. 22-02 PENSION MEMBERS No. 10-02 PENSION OPERATIONS ADVISORY COMMITTEE No. 16-02 RE: PRESIDENT SIGNS INTO LAW H.R. 3090, THE "JOB CREATION AND WORKER ASSISTANCE ACT OF 2002" The Job Creation and Worker Assistance Act of 2002 (the “Act”), which was signed into law by President Bush on March 9, 2002, includes a number of provisions of interest to retirement plan service providers, regulated investment companies (RICs) and their shareholders. In particular, the Act (1) makes technical changes to certain pension provisions included in the “Economic Growth and Tax Relief Reconciliation Act of 2001” (EGTRRA), (2) removes statutory impediments to electronic delivery of tax information returns to shareholders under certain enumerated Code1 sections, including IRS Form 1099-DIV, and (3) modifies the taxation of securities futures contracts. As some of these provisions are quite detailed, please refer to the attached text of the Act and technical explanation prepared by the Joint Committee on Taxation.2 I. Technical Corrections to EGTRRA3 Deemed IRAs. EGTRRA provided that if an eligible retirement plan permits employees to make voluntary employee contributions to a separate account or annuity that meets the requirements applicable to traditional IRAs or Roth IRAs (and certain other 1 All references herein to the “Code” or “Code sections” are to the Internal Revenue Code of 1986, as amended. 2 The text of the Act can be found online at http://thomas.loc.gov (search for H.R. 3090 and select the “Enrolled Bill” — H.R.3090.ENR). The Joint Committee’s explanation can be found at http://www.house.gov/jct/x-12-02.pdf. 3 For a summary of the retirement and education savings provisions of EGTRRA, see Institute Memorandum to Pension Members No. 21-01 and Pension Operations Advisory Committee No. 35-01, dated May 31, 2001. The EGTRRA technical corrections are contained in section 411 of the Act and explained in pages 37 to 42 of the technical explanation. 2 requirements), the separate account is deemed to be a traditional IRA or Roth IRA, as applicable. The Act clarifies that for purposes of a “deemed IRA,” the term “qualified employer plan” includes the following types of plans maintained by a governmental employer: a qualified plan under Code section 401(a), a qualified annuity plan under section 403(a), a 403(b) plan, and an eligible deferred compensation plan under 457(b). The Act also clarifies that ERISA is intended to apply to deemed IRAs in a manner similar to SEPs. Benefit and Contribution Increases. Because of the benefit and contribution limit increases enacted by EGTRRA, a new “base period” applies in indexing the 2002 dollar amounts for certain future cost-of-living adjustments. The Act makes conforming changes to the limits set forth in Code sections 408(k) and 409(o) in order for future indexing to operate properly.4 Top-Heavy Rules and

the Same-Desk Rule. EGTRRA repealed the “same desk” rule and made certain modifications to the top-heavy rules applicable to retirement plans. The Act clarifies that distributions made after severance from employment (rather than separation from service) are considered for only one year in determining top-heavy status under a plan. SEP Deduction Limits. EGTRRA increased the Code section 404(h)(1) annual limitation on the amount of deductible contributions that can be made to a SEP from 15 percent of compensation to 25 percent. The Act makes a conforming change (from 15 percent to 25 percent) to Code section 402(h)(2)(A) — the provision that limits the amount of SEP contributions that may be made for a particular employee. Notably, the Joint Committee’s explanation regarding this provision states that the Treasury Secretary, under present law, has the authority to require an employer making contributions to a SEP to provide simplified reports for such contributions, and that “consistent with present law,” reports could include information as to compliance with the SEP requirements, including the contribution limits for SEPs. In addition, the Act clarifies that elective deferrals made to SEPs are not subject to the deduction limits and are not taken into account in applying the limits to other SEP contributions. Combined Deduction Limit. The Act clarifies that the combined deduction limit of 25 percent of compensation for defined benefit and defined contribution plans does not apply if the only amounts contributed to the defined contribution plan are elective deferrals. 4 The Act also addresses the unintended effect of EGTRRA’s benefit limit increases on defined benefit plans that incorporate the increases by reference and operate on a non-calendar year basis. Specifically, the Act allows an employer to amend such a plan by June 30, 2002, to reduce benefits to pre-EGTRRA levels without violating the anticutback rules under Code section 411(d)(6). 3 Nonrefundable Credit for Contributions to Plans and IRAs. EGTRRA established a nonrefundable tax credit for elective contributions made by eligible taxpayers to certain employer-sponsored retirement plans and IRAs. The Act provides that the amount of contributions taken into account to determine the credit for such contributions is reduced by the amount of distributions from the plan or IRA that is includible in income or that consists of after-tax contributions. Rollover distributions or trustee-to-trustee transfers to another retirement plan do not affect the credit. Credit for Small Plan Start-up Costs. EGTRRA provided a nonrefundable tax credit for certain plan-related expenses of a small employer that adopts a new qualified defined benefit plan, defined contribution plan, SIMPLE plan, SEP or payroll deduction IRA program. The Act clarifies that this tax credit applies in the case of a plan first effective after December 31, 2001, even if adopted on or before that date. Catch-up Contributions. EGTRRA permitted catch-up contributions to be made by individuals age 50 or over to retirement plans. The Act makes a number of changes to the rules that govern catch-up contributions.5 In particular, the Act: • clarifies that the applicable catch-up limit applies to all qualified retirement plans, tax-sheltered annuity plans, SEPs and SIMPLE plans maintained by the same employer on an aggregated basis, as if all plans were a single plan; the Act also clarifies that the limit applies to all eligible deferred compensation plans of a government employer on an aggregated basis; • provides that the total amount that an individual may exclude from income as catch-up contributions for a year cannot exceed the catch-up limit for that year, without regard to whether the individual made catch-up contributions under plans maintained by more than one employer; • provides that an individual who is projected to attain age 50 by the end of the taxable year is a catch-up eligible individual; • clarifies that a participant in an eligible 457 plan of a government employer may make catch-up contributions in an amount equal to the greater of the amount “regular” catch-up contribution (under Code section 414(v)) and the amount permitted under the special catch-up rule for eligible 457 plans; and • clarifies that catch-up contributions can only be made to qualified defined contribution plans, not defined benefit plans, and incorporates, for purposes of the “universal availability” requirement, the “transition period” under Code section 410(b)(6)(C) for mergers and acquisitions. 5 Notably, these statutory changes are largely consistent with the guidance issued by the IRS in its proposed regulations on catch-ups. See Institute Memorandum to Pension Members No. 32-01 and Pension Operations Advisory Committee No. 67-01, dated October 23, 2001; 66 Fed. Reg. 53555 (October 23, 2001). 4 Equitable Treatment for Contributions to Defined Contribution Plans. The Act clarifies that the contribution limits governing 403(b) plans apply in the year the contributions are made, without regard to when the contributions become vested. The Act also provides that contributions to a 403(b) plan may be made for an employee for up to five years after retirement, based on the includible compensation for the last year of service before retirement. Additionally, the Act restores special rules for ministers, employees of churches, and foreign missionaries that were inadvertently eliminated from the Code. Definition of Compensation for 457 Plans. The Act conforms the definition of “includable compensation” in Code section 457(e)(5) (applicable to 457 plans) to the section 415(c)(3) definition of compensation (applicable to defined contribution plans). Rollovers of After-Tax Contributions. EGTRRA expanded the portability of retirement assets by, among other things, allowing the rollover of after-tax contributions under certain circumstances. The Act clarifies that only a “qualified trust” which is part of a defined contribution plan or a traditional IRA may receive after-tax amounts by direct rollover. In addition, the Act provides an ordering rule for rollovers from plans with after-tax amounts. Specifically, if a distribution includes both pretax and after-tax assets, the portion of the distribution that is rolled over is treated as consisting first of pretax amounts. Disregarding Rollovers for Purposes of Cash-out Amounts. EGTRRA permitted plans to disregard rollover amounts when determining the present value of a participant’s accrued benefit for purposes of making involuntary “cash-out” distributions from the plan. The Act clarifies that rollover amounts may be disregarded also in determining whether a spouse must consent to the cash-out benefit. Defined Benefit Plan Provisions. In addition to those noted above, the Act contains other technical corrections applicable only to defined benefit plans. These include changes with regard to (1) the notice of significant reduction in plan benefit required by EGTRRA and (2) the timing rules for plan valuations. The Act’s non-technical correction provisions relating to defined benefit plans include those relating to (1) the interest rate used in determining additional required contributions; (2) PBGC premiums applicable to defined benefit plans. ESOP Dividends. EGTRRA expanded the deductibility of dividends in ESOPs. The Act provides that (1) a reinvested dividend in qualifying employer securities at the participant’s election must be nonforfeitable, and (2) the deduction for dividends reinvested in qualifying employer securities at the election of participants is allowable for the taxable year in which the later of the reinvestment or the election occurs. Effective Date. The technical corrections to EGTRRA are generally effective as if they had been included in the provisions of EGTRRA. 5 II. Electronic Delivery of IRS Forms 10996 The Act removes statutory impediments (i.e., first-class mailing requirements) to electronic delivery of tax information returns under certain enumerated Code sections, including IRS Forms 1099-DIV and 1099-INT.7 For this purpose, a recipient must consent to electronic delivery of the covered forms in a manner similar to the one permitted for purposes of electronic delivery of IRS Form W-28 or in such other manner as provided by the IRS. The attached technical explanation notes that, under present law, the IRS has authority to issue rules under which IRS Forms 5498 and 1099-R may be provided to taxpayers electronically. The provision is effective on date of enactment. III. Taxation of Securities Futures Contracts9 The Act makes three changes to the taxation of securities futures contracts, as initially provided by the “Community Renewal Tax Relief Act of 2000” (CRTRA). Sale, Exchange or Termination of Securities Futures Contracts. CRTRA subjected dealer securities futures contracts to taxation under Code section 1256. Under CRTRA, gain or loss from the cancellation, lapse, expiration or other termination of a non-dealer securities futures contract was treated as a capital gain or loss under Code section 1234A. However, gain or loss from the sale or exchange of a securities futures contract was determined by reference to the underlying property to which the contract relates under Code section 1234B. The Act eliminates this potentially disparate treatment of terminations and dispositions of non-dealer securities futures contracts by (1) removing securities futures contracts from Code section 1234A and (2) expanding Code section 1234B to cover the "sale, exchange or termination" of securities futures contracts. Short Sale Treatment. The Act adds Code section 1233(e)(2)(E) expressly to provide that entering into a securities futures contract to sell will be considered a short sale and that settlement of such a contract will be considered the closing of a short sale. 6 The electronic delivery provision is contained in section 401 of the Act and explained on page 27 of the technical explanation. 7 The Act specifically refers to tax information returns provided to consenting taxpayers under Code sections 6041 to 6050S. 8 See Temp. Treas. Reg. 31.6051-1T(j) and Institute Memorandum to Tax Committee No. 29-01, dated November 13, 2001. 9 The provisions modifying the taxation of securities futures contracts are contained in section 412 of the Act and explained on page 43 of the technical explanation. 6 Application of Wash Sale Rules. The Act revises Code section 1091(e) expressly to provide that losses realized on the sale, exchange or termination of a non-dealer securities futures contract to sell are subject to the wash sale rules.10 Effective Date. Each of the above changes are effective as if included in the provisions of CRTRA. Deanna J. Flores Thomas T. Kim Associate Counsel Associate Counsel Note: Not all recipients receive the attachments. To obtain copies of the attachments, please visit our members website (http://members.ici.org) and search for memo 14553, or call the ICI Library at (202) 326-8304 and request the attachments for memo 14553. Attachment no. 1 (in .pdf format) 10 The Act also adds Code section 1256(f)(5) to clarify that mark-to-market losses under Code section 1256 are not subject to the wash sale rules. The addition of Code section 1256(f)(5) is effective as if included in the provisions of the "Technical and Miscellaneous Revenue Act of 1998" and may be found in section 416 of the Act.
