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MEMORANDUM TO CLIENTS

Re: Legislative Update

In the last several weeks, the House and Senate haggled over and have now passed pension funding relief legislation, and there has been some renewed activity on legislation to change the rules for nonqualified deferred compensation plans. Here is our update on recent developments.

A. Funding Legislation

Last year, the House passed legislation (H.R. 3108; H.R. 3521) to temporarily replace the 30-year Treasury interest rate with a composite corporate bond rate for funding purposes for the 2004 and 2005 plan years. On January 28, the Senate passed similar 30-year Treasury replacement legislation (H.R. 3108), but also included partial deficit reduction contribution (DRC) relief for airlines and steel companies, a DRC waiver application process for other companies, and several amendments related to multiemployer pension plans.

Over the last month, House and Senate conferees engaged in sometimes contentious negotiations to reconcile the differences between the two versions of H.R. 3108. Negotiations were complicated by concerns raised by the White House and House Republicans regarding the multiemployer plan relief provisions in the Senate bill. On March 4, the White House released a letter to conferees from key Bush Administration officials stating that they would recommend a Presidential veto of the legislation if it contained the DRC waiver application and multiemployer plan relief provisions in the Senate bill. Negotiations on the bill became contentious late in the week of March 22 when a possible deal regarding the scope of the multiemployer plan relief provisions was scuttled because of White House concerns. On April 1, the conferees finally agreed to a conference report by a straight party-line vote after House Republicans and the White House insisted on a significantly scaled-back version of the multiemployer plan relief provisions.

The House passed the conference report by a vote of 336-69 on April 2. The Senate passed the conference report by a vote of 78-19 on April 8 after Senate Democrats decided not to filibuster the bill (despite the watered down multiemployer plan relief provisions). President Bush is expected to sign the bill as early as next week, just before the April 15 deadline for quarterly contributions. The legislation is expected to produce net revenues for the government of about $9 billion over the next two fiscal years primarily by postponing deductions for over $80 billion in pension contributions for 2004 and 2005.

We expect Treasury to issue guidance regarding calculation of the DRC and quarterly contribution requirements under the legislation immediately after the President signs the bill into law.

A brief summary of the key pension-related provisions in the conference report follows.

30-Year Treasury Interest Rate Replacement. The 30-year Treasury interest rate is temporarily replaced with a composite corporate bond rate for funding purposes for the plan years beginning in 2004 and 2005. For those years, the interest rate used for purposes of determining a plan's current liability must be within 90 to 100 percent of the 4-year weighted average of the "rates of interest on amounts invested conservatively in long-term investment grade corporate bonds." Treasury is directed to prescribe a method for determining conservative corporate bond rates based on the use of two or more indices that are in the top three quality levels available. A composite corporate rate is also used for purposes of determining PBGC variable rate premiums for the 2004 and 2005 plan years. For purposes of determining the maximum amount of tax deductible contributions, an employer may disregard the temporary interest rate change – a provision that is generally intended to allow higher deductible amounts.

Deficit Reduction Contribution Relief for Certain Plans. Defined benefit plans maintained by commercial passenger airlines and steel companies get two years of partial relief from the DRC requirements – but only if the plans were not subject to those requirements for the plan year beginning in 2000. For the two plan years beginning after December 27, 2003, and before December 28, 2005, eligible airline and steel plans generally are required to pay only the greater of: (1) 20 percent of the otherwise applicable DRC requirement, or (2) the additional contribution that would be required if the DRC requirement for the year was determined as the expected increase in current liability due to benefits accruing during the plan year. Notice requirements and certain restrictions on the ability to increase benefits apply to plans that elect the relief. The provision in the Senate bill that would have permitted employers in other industries to apply for the relief was dropped.

Section 415/Anti-Cutback Provisions. The bill contains a transition rule for making certain section 415 calculations for 2004 and 2005. Under current law, the GATT interest rates (if greater than the plan's rate) must be used to make certain 415 adjustments for lump-sum distribution and other non-annuity forms. The legislation substitutes a uniform rate of 5.5% for GATT rates for this purpose. The legislation also provides anti-cutback relief for plan amendments made "pursuant to any amendment" made by the legislation.

Temporary Funding Relief for Certain Multiemployer Plans. Certain eligible multiemployer plans are permitted to elect temporary relief regarding the deferral of certain charges to the funding standard account. To be eligible, the multiemployer plan is required to have had an actual net investment loss for the first plan year beginning after December 31, 2001, of at least 10 percent of the average fair market value of plan assets, have a projected accumulated funding deficiency for any plan year beginning after June 30, 2003, and before July 1, 2006, and meet certain other requirements. Certain notice requirements and restrictions on the ability to increase benefits apply to plans that elect the relief.

Multiemployer Plan Funding Notices. For 2005 and later plan years, multiemployer pension plans are required to provide an annual funding notice which includes, among other things, (1) a statement as to whether the plan's funded current liability percentage is at least 100 percent and, if not, a statement of the percentage; and (2) a statement of the value of the plan's assets, the amount of benefit payments, and the ratio of the assets to the payments for the plan year.

8-Year Extension For Certain Transfers of Excess Pension Assets to Retiree Health Accounts. Under current law and through December 31, 2005, a defined benefit plan may make a qualified transfer of excess pension assets to a separate retiree health account within the plan (Code section 420). Under the bill, qualified transfers are permitted through December 31, 2013.

B. COLI and Nonqualified Deferred Compensation Legislation

Significant changes in the rules that apply to nonqualified deferred compensation arrangements have been pending in Congress as part of Enron-related pension legislation in the Senate, and international and corporate tax reform legislation in the House. There has been some activity regarding this legislation in recent weeks, but it remains unclear whether the nonqualified deferred compensation changes will be enacted this year. Here is an update on recent developments.

Senate Finance Committee Pension Reform Bill

In February, the Senate Finance Committee approved a revised version of the corporate owned life insurance (COLI) amendment previously added to Enron-related pension reform legislation. Also during the mark-up, the Finance Committee moved the effective date of the nonqualified deferred compensation amendments in the underlying bill to amounts deferred in taxable years beginning after December 31, 2004.

Under the revised COLI amendment adopted by the Committee, death benefits paid under a COLI policy would be taxable to the extent the benefits exceed the premiums or other amounts paid for the contract unless certain notice and consent requirements are satisfied and –

- the insured individual was an employee within 12 months of death;
- the death benefits are payable to the individual's family, designated beneficiary, a trust for the benefit of such persons, or the individual's estate, or are used to purchase an equity interest in the employer from any of such persons; or
- the individual is a "highly compensated employee" under Code section 414(q) (without regard to the top-paid group rules) or a "highly compensated individual" under IRC section 105(h)(5) with a salary in the top 35 percent of employees, including any director.

Under the proposed notice and consent requirements, the employee must, prior to the issuance of the contract – (1) be notified in writing of the coverage and the maximum face amount of the policy at the time of issuance, (2) be informed that the employer will be the beneficiary of any proceeds payable under the policy, and (3) provide written consent to being insured and to the coverage continuing after the employee's termination of employment. The amendment also would require employers who maintain COLI programs to satisfy certain IRS reporting requirements. The proposed COLI changes would be effective for contracts issued after the date of enactment, with exceptions for contracts issued after the date of enactment pursuant to a 1035 exchange for a contract issued prior to the date of enactment.

Despite the Finance Committee's action on the pension reform bill, it is unlikely that the bill will be considered on the Senate floor this year.

International and Corporate Tax Reform Bill

In March, the nonqualified deferred compensation amendments included in the Finance Committee's Enron-related pension reform legislation were added to the international and corporate tax reform bill (S. 1637) under consideration on the Senate floor. The nonqualified plan amendments added to the Senate international and corporate tax reform bill generally mirror those in the Finance Committee's pension reform bill, but contain certain technical changes and do not include the COLI amendments or the repeal on the longstanding limitation on Treasury's ability to issue guidance in the deferred compensation area (sec. 132 of the Revenue Act of 1978). The proposed amendments would be effective for amounts deferred in taxable years beginning after December 31, 2004. Treasury would be directed to provide participants with a limited period of time after the date of enactment to terminate participation in the plan or cancel an outstanding deferral election with regard to amounts earned after December 31, 2004.

Progress on Senate consideration of the international and corporate tax reform bill has been slowed by partisan disputes regarding whether and to what extent Senate Democrats will be permitted to offer certain non-germane amendments to the bill. Thus far, the Senate has failed to approve two motions for "cloture" that would have limited the amount of debate and number of amendments on the bill. As we go to press, Senate Republicans and Democrats appear to be closer to a compromise on the number and type of amendments on the bill. If an agreement is reached, the Senate could resume its consideration of the bill the week of April 19 after it returns from Easter recess.

As previously reported, the version of international and corporate tax reform legislation (H.R. 2896) approved by the House Ways and Means Committee also contains a package of amendments to the nonqualified deferred compensation rules. Progress on the House version of the legislation has been stalled for months because of concerns from House Democrats and some Republicans regarding the distribution of tax reforms between international tax and domestic manufacturing tax concerns. To date, House Ways and Means Committee Chairman Bill Thomas (R-CA) and House leadership have not been able to muster the votes needed to bring to the floor and pass the legislation. Most recently, Chairman Thomas stated that he would be open to making changes to improve the bill, but that future House action on the legislation will depend upon whether the Senate is able to pass its version of the bill.

A side-by-side comparing the nonqualified deferred compensation changes in the current versions of international and corporate tax reform legislation under consideration in the House and Senate is attached.