DESCRIPTION OF THE PENSION PROVISIONS

OF THE

TAX EQUITY AND FISCAL RESPONSIBILITY ACT OF 1982

SCHEDULED FOR A HEARING

before the

SUBCOMMITTEE ON
SAVINGS, PENSIONS,
AND INVESTMENT POLICY

OF THE

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INTRODUCTION

The Subcommittee on Savings, Pensions, and Investment Policy of the Senate Committee on Finance has scheduled a hearing on April 11, 1983, on the effect of changes made in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) on the private pension system.

This document, prepared by the staff of the Joint Comittee on Taxation in connection with the Subcommittee hearing, provides a description of the pension provisions of TEFRA. The first part is an overview, and is followed in the second part by a more detailed description of the pension provisions of TEFRA.

I. OVERVIEW

If a pension, profit-sharing, or stock bonus plan qualifies under the tax law (sec. 401(a), 403(a), 405(a)), then (1) a trust under the plan is generally exempt from income tax, (2) employers are generally allowed deductions (within limits) for plan contributions for the year for which the contributions are made, even though participants are not taxed on plan benefits until the benefits are distributed, (3) benefits distributed as a lump sum distribution may be accorded special long-term capital gain treatment or 10-year income averaging treatment, or may be rolled over, tax-free, to an individual retirement account or annuity (IRA) or to another qualified plan, and (4) certain estate and gift tax exclusions are provided.

Under a tax-sheltered annuity program, amounts paid by an educational institution or by an eligible tax-exempt organization to purchase an annuity contract for an employee are excluded from the employee's income, subject to certain limits (sec. 403(b)). Amounts distributed or made available under tax-sheltered annuities or custodial accounts generally are includible in gross income. However, certain total distributions may be rolled over, tax-free, to another such annuity contract or to an IRA. In addition, certain estate and gift tax exclusions apply.

If an IRA qualifies as a simplified employee pension (SEP), the annual IRA deduction limit (generally, the lesser of $2,000 or 100 percent of compensation) is increased by the lesser of $15,000 or 15 percent of compensation. The increase in the deduction limit applies only to employer contributions (sec. 219).

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs. The dollar limit on the annual addition under defined contribution plans was decreased from $45,475 to $30,000. The dollar limit on employer-provided annual benefits for an employee under defined benefit plans was decreased from $136,425 to $90,000. In addition, the Act suspended cost-of-living adjustments to these limits through 1985.

TEFRA also provided rules to achieve parity between corporate and noncorporate pension plans. Additional qualification rules are applied to certain plans (top-heavy plans) which focus benefits on key employees. These special provisions include special vesting schedules and minimum benefit or contribution requirements for top-heavy plans.

In addition, TEFRA provided a limit on borrowing from qualified pension, etc., plans and tax sheltered annuities. Loans in excess of the limit are treated as distributions and may be includible in gross income.

TEFRA also modified the rules relating to retirement plans for church employees, State judicial retirement plans, profit-sharing contributions for disabled employees, and group trusts. A nondiscrimination rule was added for employer-provided group term life insurance.

II. DESCRIPTION OF PENSION PROVISIONS OF TEFRA

A. Limits on Contributions and Benefits (secs. 401, 404, 415, 1379, and 2039 of the Code)

1. Overall limits

The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) made several changes to the overall limits on contributions and benefits under qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on the annual addition under defined contribution plans was decreased from $45,475 to $30,000. The dollar limit on employer-derived annual benefits for an employee under defined benefit plans was decreased from $136,425 to $90,000.

Under the rules relating to the overall limit on annual benefits, the value of benefits paid in a form other than a single life annuity may not exceed the actuarial equivalent of a single life annuity equal to the applicable limit . The assumed interest rate is a key factor in determining actuarial equivalence. Under TEFRA, actuarial equivalence is generally determined by using an interest rate assumption of not less than the greater of five percent or the rate (if any) specified in the plan for purposes of converting a plan benefit into an actuarially equivalent optional benefit.

TEFRA suspended cost-of-living adjustments to the overall dollar limits. The $30,000 and $90,000 limits, first effective in 1983 for plans in existence on July 1, 1982, will not be increased in 1983, 1984, or 1985. Beginning in 1986, the limits will be adjusted for post-1984 cost-of-living increases under the formula then in effect to provide cost-of-living increases in social security benefits.

2. Dollar limits for benefits payable upon early or delayed retirement

Under TEFRA, if retirement benefits under a defined benefit plan begin before age 62, the $90,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 62. However, TEFRA provided that in no event will the dollar limit for benefits commencing at or after age 55 be reduced below $75,000.

TEFRA also provided that if retirement benefits under a defined benefit plan begin after age 65, the $90,000 limit is increased so that it is the actuarial equivalent of an annual benefit of $90,000 beginning at age 65. The increase is to be computed using an interest rate assumption not greater than the lesser of five percent or the rate specified in the plan.

TEFRA does not prohibit an employee from retiring before age 62, and does not mandate actuarial reductions in plan benefits commencing prior to age 62 if the limits are not exceeded. Similarly, TEFRA does not require that a plan provide increased benefits for participants retiring after age 65.

3. Aggregate limit

If an employee participates in a defined contribution plan and a defined benefit plan maintained by the same employer, a fraction of the separate limit used by each plan is computed and the sum of the fractions is subject to an overall limit of 1.0 (sec. 415(e)).

4. Deduction limits

TEFRA provided that no deduction is permitted for any year for employer contributions used to provide any benefits or annual additions in excess of the limits applicable for that year. In addition, the Act clarified prior law by providing that an employer's deduction limit for the year under a defined benefit plan may not be based on benefits in excess of the dollar limit applicable for the year (without regard to anticipated cost-of-living increases in the limits). Deductions may, however, be based on benefits (not in excess of the dollar limits for the current year) which take into account anticipated salary increases.

5. Estate tax exclusions

TEFRA placed a $100,000 aggregate limit on the estate tax exclusion for certain retirement benefits payable under qualified pension, etc., plans, tax-sheltered annuities, individual retirement accounts, annuities, or bonds (IRAs), and certain military retirement plans (sec. 2039). This estate tax exclusion for retirement benefits is allowed in addition to any other exclusion or deduction (<u>e.g.</u>, the marital deduction (sec. 2056)) allowed with respect to such benefits.

6. Effective dates

<u>In general</u>

For plans not in existence on July 1, 1982, the provisions reducing the overall limits apply to years ending after July 1, 1982.

For plans in existence on July 1, 1982, the provisions generally apply to years beginning after December 31, 1982. However, a plan which was in existence on July 1, 1982, will not fail to be qualified for any year beginning before January 1, 1984, merely because the plan may provide benefits or contributions which, though not exceeding the overall limits in effect prior to the amendments made by TEFRA, exceed the limits as amended.

The provisions which suspend the cost-of-living adjustments apply to adjustments which would have been made in years beginning after December 31, 1982, and before January 1, 1986. Thus, any adjustments to the dollar limits that would otherwise be made after December 31, 1982, and before January 1, 1986, will not be made.

Collectively bargained plans

TEFRA provided a special effective date for plans maintained on the date of enactment (September 3, 1982) pursuant to one or more collective bargaining agreements between employee representatives and one or more employers.

Transitional rules

Current accrued benefits

TEFRA provided a transitional rule to insure that a participant's previously accrued benefit under a defined benefit pension plan is not reduced merely because the Act reduced the dollar limits on benefits payable under the plan.

Aggregate limit

TEFRA provided a special transitional rule to grant a "fresh start" for individuals who participate in both a defined benefit plan and a defined contribution plan maintained by the same employer.

B. Loans to Plan Participants (sec. 72 of the Code)

1. Loans treated as distributions

Under prior law and present law, a qualified plan, etc., generally is permitted to make a loan to a plan participant if the loan (1) bears a reasonable rate of interest, (2) is adequately secured, (3) provides a reasonable repayment schedule, and (4) is made available on a basis that does not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 4975(d)). If an individual borrows from an IRA or uses amounts in an IRA as security for a loan, the transaction is treated as a distribution and the usual income tax rules for IRA distributions apply (secs. 72(m) and 408(e)).

Under rules added by TEFRA, any amount received (directly or indirectly) by a participant as a loan from (1) a qualified pension, etc., plan, (2) a governmental plan (whether or not a qualified plan), or (3) a tax-sheltered annuity contract, is also treated as a distribution unless certain requirements are met.

2. Limitation with respect to loan amounts

Under TEFRA, a loan that, by its terms, is to be repaid within 5 years generally is treated as a distribution to the extent that the amount of the loan, when added to the outstanding loan balance (principal plus interest) with respect to the employee under all plans of the employer exceeds the lesser of (1) $50,000 or (2) one-half of the present value of the employee's nonforfeitable accrued benefit under such plans. However, no loan is treated as a distribution under this provision to the extent that the amount of the loan, when added to the outstanding loan balance with respect to the employee, totals $10,000 or less. Under TEFRA, the outstanding loan balance with respect to an employee includes unpaid amounts under loans which were outstanding on August 13, 1982.

3. Limitation with respect to repayment period

Any loan made with respect to an employee under a qualified plan, etc., which is not required to be repaid within 5 years generally is treated as a distribution. For this purpose, the period within which a loan is required to be repaid is determined at the time the loan is made. If a repayment period of less than 5 years is subsequently extended beyond 5 years, the balance payable under the loan at the time of the extension is to be treated as distributed at the time of the extension. In addition, if payments under a loan with a repayment period of not more than 5 years are not in fact made, so that an amount remains payable after the end of 5 years, the amount remaining payable at the end of 5 years is treated as if distributed at the end of the 5-year period.

TEFRA provided an exception to the 5-year repayment rule to the extent that a loan made with respect to a plan participant is applied toward acquiring, constructing, or substantially rehabilitating a house, apartment, condominium, or mobile home which is used or is to be used within a reasonable time as the principal residence of the participant or a member of the participant's family.

4. Application of distribution rules

The usual income tax rules for distributions from qualified plans, etc., apply to loan amounts which are treated as distributions under TEFRA. Under the distribution rules, a recipient is deemed to receive first any nondeductible contributions under the plan. Thus, a loan amount which is treated as a distribution is includible in the recipient's gross income only to the extent that such amount exceeds the net amount of nondeductible employee contributions under the plan under which the loan is made.

5. Loan repayments

Repayments of loans (including loans treated as distributions) are not considered employee contributions for purposes of those rules limiting nondeductible employee contributions and annual additions on behalf of an employee under qualified plans and tax-sheltered annuity contracts (sec. 415) or those rules allowing an employee a deduction for certain voluntary contributions under an employer's plan (sec. 219).

For purposes of the income tax rules for taxation of distributions, repayments of amounts previously treated as distributions and included in gross income under the new loan rules are to be treated as nondeductible employee contributions. Under this rule, a distribution of amounts consisting of loan repayments, which were previously included in gross income, will not be included in gross income again. Accordingly, the participant is not taxed on the same amount when a loan is treated as a distribution and again when the repaid amount is distributed.

6. Plan qualification

TEFRA made no changes to the prior-law prohibited transaction rules (sec. 4975(e)) and fiduciary standards for qualified pension plans, etc. Although TEFRA changed the tax treatment of certain plan loans, it did not modify the tax-qualification standards of the Code for pension, profit-sharing, or stock bonus plans or the non-Code rules of ERISA.

If a loan would have been treated as a distribution under prior law, TEFRA did not change the prior law results with respect to either the income tax consequences to the individual or the effect of the distribution upon the qualification of the plan making the distribution.

7. Loans to self-employed individuals and shareholder-employees

TEFRA did not revise the prior law rules (sec. 4975(d)) under which a loan to an owner-employee under an H.R. 10 plan or to a shareholder-employee under a qualified plan of a subchapter S corporation is considered a prohibited transaction subject to certain excise tax sanctions. Similarly, the Act did not revise the prior law qualification rules (sec. 401(a)(13)) under which a loan which is a prohibited transaction may be a prohibited assignment or alienation of plan benefits. However, TEFRA repealed, for plan years beginning after December 31, 1983, the rule under which an H.R. 10 plan generally was precluded from paying benefits to an owner-employee (including payments in the form of a loan made to the owner-employee) before the owner-employee attains age 59 1/2.

The Act repealed, for loans made after August 13, 1982, those rules under which any loan made to a self-employed individual (whether or not an owner-employee) under an H.R. 10 plan is treated as a distribution to the individual under the income tax rules. Under TEFRA, the new loan rules are applied with respect to loans to self-employed individuals under H.R. 10 plans on the same basis as the new rules are applied with respect to loans to common-law employees.

8. Certain mortgage loans

Under TEFRA, investments (including investments in residential mortgages) which are made in the ordinary course of an investment program are not considered as loans if the amount of the mortgage loan does not exceed the fair market value of the property that is purchased with the loan proceeds and subject to the mortgage. An investment program exists, for example, when trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages under specified conditions. However, mortgage loans made as a result of the direction of investments of an individual account are not considered as made under an investment program and no loan which benefits an officer, director, or owner (or their beneficiaries) is treated as an investment.

TEFRA's provisions do not otherwise affect the prior-law rules relating to whether a transaction is a loan made with respect to a plan participant or an investment of plan assets.

9. Effective dates

In general

TEFRA's provisions generally apply to loans made after August 13, 1982.

Qualified refunding loan

Under a special transitional rule, a qualified refunding loan made after August 13, 1982, and before August 14, 1983, (including a demand loan outstanding on August 13, 1982) generally is not treated on the date of the loan as a distribution under TEFRA's provisions. A qualified refunding loan is a loan used to make a required principal repayment on a loan that was outstanding on August 13, 1982, if that repayment is required to be made before August 14, 1983. Any amount outstanding under a qualified refunding loan on August 14, 1983, is treated as a loan made on that date.

C. Parity under the Qualified Plan Rules for Corporate and Noncorporate Employers; Group-term Life Insurance (Secs. 72, 79, 219, 269A, 401, 404, 405, 408, 414, 415, 416, and 1379 of the Code)

1. Overview

TEFRA generally eliminated distinctions in the tax law between qualified pension, etc., plans of corporations and those of self-employed individuals (H.R. 10 plans). The Act (1) repealed certain of the special rules for H.R. 10 plans, (2) extended other of the special rules to all qualified plans, including those maintained by corporate employers, and (3) generally applied the remainder of the special rules, with modifications, only to those plans (whether maintained by a corporate or noncorporate employer) that favor the employer's key employees (top-heavy plans). The top-heavy plan rules were provided in addition to the usual rules for plan qualification and the treatment of distributions.

The special rules for H.R. 10 plans that were repealed include those which (1) set lower limits on contributions and benefits for self-employed individuals, (2) precluded an H.R. 10 plan benefitting an owner-employee from limiting coverage to a fair cross section of employees, and (3) precluded integrating such a plan with social security benefits. The corresponding limitations applicable to subchapter S and SEPs were also repealed.

The special rules for H.R. 10 plans that were extended to all qualified plans relate to (1) distributions made to the employee or to the employee's beneficiaries after the employee's death and (2) integration of a defined contribution plan with social security.

The special rules for H.R. 10 plans that generally were extended (with modifications) to plans of corporate and noncorporate employers that favor key employees (top-heavy plans) included those rules relating to (1) includible compensation, (2) vesting (alternative schedules were provided), and (3) distributions. The rules for a top-heavy plan also require that such a plan provide a non-key employee a nonintegrated minimum benefit or a nonintegrated minimum contribution and, in some cases, reduce the overall limits on contributions and benefits for a key employee who is covered by more than one plan of an employer.

These provisions apply for years beginning after December 31, 1983.

2. Repeal of rules for H.R. 10 plans

Deductible contributions and permitted benefit accruals

TEFRA generally repealed the special deduction limits (sec. 404(e)(1),(2), and (4)) for contributions on behalf of a self-employed individual under an H.R. 10 profit-sharing plan. Under TEFRA, the maximum amount of employer contributions and other annual additions for a self-employed individual is determined pursuant to the overall limits on contributions and benefits (sec. 415) rather than the employer deduction rules. Thus, annual additions for a self-employed individual equal to the lesser of 25 percent of the individual's compensation or $30,000 generally are permitted (sec. 415(c)). The employer's deduction for plan contributions continues to be limited under the usual rules for deductions (sec. 404).

In addition, TEFRA repealed the special qualification rules for a defined benefit H.R. 10 plan or subchapter S plan (sec. 401(j)). Such defined benefit plans will be subject to the rules applicable to defined benefit plans maintained by corporate employers.

Repeal of the special rules for defined benefit H.R. 10 and subchapter S plans permits a self-employed individual or shareholder-employee who participates in both a defined benefit plan and a defined contribution plan of the same employer increased aggregate contributions and benefits, as determined under the overall limits on contributions and benefits under qualified plans (sec. 415(e)). In addition, beginning in 1986, cost-of-living adjustments will also apply to the dollar limits applicable to an H.R. 10 plan, to a subchapter S plan, or to a SEP.

Earned income

For purposes of the pension rules, TEFRA revised the definition of earned income of self-employed individuals so that the amount of earned income corresponds to the amount of compensation of a common-law employee. Under the Act, earned income is computed after taking into account contributions by the employer to a qualified plan to the extent a deduction is allowed for the contributions. Also, in this regard, no change was made to the prior law rule (sec. 401(d)(11)) for owner-employees that has the effect of limiting the earned income that may be taken into account under the pension rules to that derived from the trade or business with respect to which the plan is established.

Coverage

TEFRA repealed the additional qualification requirement under which an H.R. 10 plan benefitting an owner-employee generally was required to benefit all employees who completed at least three years of service with the employer (sec. 401 (d)(3)(A)). However, TEFRA did not change prior law rules that required aggregation of employees of all unincorporated trades and businesses controlled by an owner-employee.

Employee contributions

TEFRA repealed the special rules precluding employer contributions under an H.R. 10 plan in excess of the deduction limit (sec. 401(d)(5)), those rules limiting or precluding mandatory or voluntary employee contributions by an owner-employee (sec. 4972), and the six-percent excise tax on excess contributions made on behalf of an owner-employee.

Miscellaneous restrictions

In addition, TEFRA repealed several special restrictions that applied to H.R. 10 plans, including provisions relating to plan trustees, fixed contribution formulas for profit-sharing plans, plan contributions after a pre-age 59 1/2 distribution, and the treatment of certain death benefits.

3. Extension of certain H.R. 10 rules to all plans

Required distributions

TEFRA extended to all qualified plans the requirement that a participant's benefit must be distributed not later than (1) the taxable year in which the participant attains age 70 1/2, or (2) if later, the year in which the participant retires (sec. 401(a)(9)). Distributions may be made over the life of the participant (or lives of the participant and the participant's spouse) or over a period not exceeding the life expectancy of the participant (or the life expectancies of the participant and the participant's spouse), even if the distributions are being made to a beneficiary other than the participant or the participant and his spouse.

In addition, TEFRA extended to all qualified plans certain rules for post-death distributions. If a participant dies before the entire interest is distributed, amounts payable to a beneficiary who is not the participant's surviving spouse generally must be paid to the beneficiary within 5 years after the participant's death. Certain exceptions apply to this requirement.

The requirement that all amounts be paid to a beneficiary within 5 years after the participant's death (or the death of the participant's spouse) may not be met by the distribution of an immediate annuity contract to the beneficiary within the 5-year period.

This provision applies for plan years beginning after December 31, 1983. However, a special transition rule is provided for certain distributions made pursuant to employee designations. Conforming changes were made to the rules relating to distributions from an individual retirement account or annuity (IRA) after the death of the individual on whose behalf the IRA was established.

Integration with social security

TEFRA extended to all qualified defined contribution plans (including target benefit plans) the prior-law H.R. 10 rule under which the tax rate and wage base applicable to employers for old age, survivors, and disability insurance (OASDI) under social security are the maximum rate and base for determining the amount by which employer contributions can be reduced under plans that are integrated with social security. As under prior law, a plan may provide an integration level (i.e., wage level) which is less than the taxable wage base or, if the rate at which the plan is integrated is properly adjusted (i.e., to a rate less than the full OASDI tax rate), an integration level which is higher than the taxable wage base. The remaining prior-law rules that restricted integration with social security under an H.R. 10 defined contribution plan which benefitted an owner-employee were repealed.

4. Additional qualification requirements for top-heavy plans

Overview

Under TEFRA, additional qualification requirements were provided for plans which primarily benefit an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation which may be taken into account, (2) provide greater portability of benefits for plan participants who are non-key employees by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees. Additional restrictions were placed on distributions to key employees.

Top-heavy plans

Under TEFRA, a defined benefit pension plan is a top-heavy plan for a plan year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the plan year exceeds sixty percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the account balances of participants who are key employees for the plan year exceeds sixty percent of the sum of the account balances of all employees under the plan. In addition, a plan is top heavy if it is required to be a part of an aggregation group and the group is top heavy.

The determination date for any plan year generally is the last day of the preceding plan year. However, in the case of the first plan year of a plan, the determination date is the last day of that year.

Top-heavy groups

The Act also provided rules under which two or more plans (including terminated plans) of a single employer are aggregated to determine whether the plans, as a group, are top-heavy. The aggregation group is required to include (1) any plan which covers a key employee (including a plan maintained pursuant to a collective bargaining agreement) and (2) any plan upon which a plan covering a key employee depends for qualification under the Code's coverage or antidiscrimination rules (secs. 401(a)(4) or 410). In addition, in testing for top-heaviness, an employer may elect to expand the aggregation group to take into account any other plan maintained by the employer (including benefits considered to be provided to its employees under a plan maintained by more than one employer) if such expanded aggregation group satisfies the coverage and antidiscrimination rules.

If an aggregation group is a top-heavy group, then each plan required to be included in the group is a top-heavy plan. If the aggregation group is not a top-heavy group, then no separate plan included in the group is top-heavy even though, standing alone, the plan would be top heavy. The top-heavy rules relating to vesting, minimum benefits or contributions, and includible compensation do not apply with respect to an employee included in a unit of employees covered by a collective bargaining agreement if retirement benefits were the subject of good faith bargaining between employee representatives and the employer.

The top-heavy group rules apply to all plans of related employers which are treated as a single employer (sec. 414).

Key employees

An individual is a key employee of an employer if the individual is (1) an officer (in the case of a corporate employer), (2) one of the 10 employees owning the largest interests in the employer, (3) owns more than a 5-percent interest in the employer, or (4) owns more than a 1-percent interest in the employer and has compensation from the employer in excess of $150,000. An individual is a key employee with respect to a determination date (and for the plan year for which the determination is made) if the individual was a key employee on any day during the plan year that includes the determination date or any one of the four preceding plan years (including plan years ending before enactment of the Act and plan years for which the plan is not top-heavy).

Under the Act, an individual is considered as owning more than a 5-percent interest in a corporate employer if the employee owns more than 5 percent of the employer's outstanding stock or stock possessing more than 5 percent of the total combined voting power of all stock of the employer. An individual is also treated as owning stock owned by certain members of the individual's family or, in certain cases, by partnerships, estates, trusts, or corporations in which the individual has an interest (sec. 318). The same rules apply to determine whether an individual is a 1-percent owner.

In determining which individuals are to be treated as key employees as a result of their 1-percent or 5-percent ownership interests (but not for purposes of determining the top-10 employee-owners), ownership is tested separately with regard to each employer. For this purpose, the aggregation rules of sections 414(b), (c), and (m) do not apply. The aggregation rules of sections 414(b), (c), and (m) apply, however, for the purpose of determining whether an individual who is a 1-percent owner is a key employee with compensation in excess of $150,000.

In determining which individuals are to be treated as key employees as a result of their status as officers, the relationship between the individual and the employer (determined without regard to the aggregation rules of sections 414(b), (c), and (m)) is determinative. However, in no event will more than 50 employees of an employer (or, if lesser, the greater of 3 employees or 10 percent of all employees) be treated as key employees because of officer status with respect to any determination date. For purposes of applying this limit, the aggregation rules of sections 414(b), (c), and (m) are to apply. If an employer has more officers than the number required to be counted as key employees, the officers to be taken into account are those with the highest compensation during the year which includes the determination date. As under prior law, the determination as to whether an employee is an officer is to be made on the basis of all the facts and circumstances, including, for example, the source of the employee's authority, the term for which elected or appointed, and the nature and extent of the employee's duties.

Qualification rules

These additional rules for top-heavy plans are tax-qualification requirements. Thus, a top-heavy plan is a qualified plan, and a trust forming part of a top-heavy plan is a qualified trust, only if the additional requirements are met. In addition, except as the Secretary of the Treasury may provide by regulations, a plan (whether or not top-heavy in fact) will constitute a qualified plan only if the plan includes provisions which meet the additional qualification requirements for top-heavy plans and which will automatically take effect if the plan becomes a top-heavy plan.

Includible compensation

For any plan year for which a plan is a top-heavy plan, only the first $200,000 of any employee's compensation may be taken into account under the plan. Beginning in 1986, this $200,000 limit will be adjusted under the same rules used to adjust the overall dollar limits on contributions and benefits. Of course, no previously accrued benefit may be reduced as a result of a cost-of-living increase in the $200,000 limit. For purposes of the $200,000-rule, in the case of a self-employed individual, compensation means earned income as redefined by the Act.

Vesting

For any plan year for which a plan is a top-heavy plan, an employee's right to the accrued benefit from employer contributions must become nonforfeitable (sec. 411(a)) under a vesting schedule which satisfies one of two alternative schedules. The vesting schedules apply to all accrued benefits under the plan (including benefits accrued before the top-heavy rules apply) whether or not the accrued benefits are required by the top-heavy plan rules and whether or not they accrued while the plan was top heavy.

A plan satisfies the first alternative vesting schedule (3-year, full vesting) if a participant who has completed at least 3 years of service with the employer or employers maintaining the plan has a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions. As under prior law, a plan which provides 3-year, 100-percent vesting will not fail to satisfy the participation requirements (sec. 410(a)(1)) merely because it requires completion of 3 years of service as a condition of participation.

A plan satisfies the second alternative vesting schedule (6-year, graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of 2 years of service, 40 percent at the end of 3 years of service, 60 percent at the end of 4 years of service, 80 percent at the end of 5 years of service, and 100 percent at the end of 6 years of service with the employer.

<u>Minimum nonintegrated benefit for non-key employees</u>

A qualified pension, etc., plan which is a top-heavy plan must provide a minimum benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who was not a key employee with respect to the determination date.

A defined benefit plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than 2 percent of the employee's average annual compensation from the employer during the employee's testing period, multiplied by the employee's years of service with the employer. However, an employee's minimum benefit is not required to exceed 20 percent of such average annual compensation. All years of an employee's service otherwise required to be taken into account under the plan (sec. 411(a)), generally are required to be taken into account under the minimum benefit rules, except a year of service (1) completed in a plan year beginning before January 1, 1984, or (2) within which ends a plan year for which the plan is not a top-heavy plan.

<u>Minimum nonintegrated contribution for non-key employees</u>

For a plan year for which a defined contribution plan is a top-heavy plan, the employer generally must contribute on behalf of each plan participant who is not a key employee for the year an amount not less than 3 percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top-heavy. Thus, the required minimum contribution may not be reduced or eliminated on account of prior plan contributions merely because the participant's account balance exceeds an amount equal to 3 percent multiplied by the number of years for which the plan is top-heavy. Each participant who is not a key employee for the year is entitled to the minimum contribution if the participant is in service on the allocation date under the plan.

No required duplication of minimum benefit or minimum contribution

Under TEFRA, the Treasury is to prescribe rules to preclude inappropriate omissions or required duplications of minimum benefits or contributions. If a non-key employee participates in both a defined benefit plan and a defined contribution plan included in a top-heavy group, the employer is not required by the Act to provide the non-key employee with both the full, separate minimum benefit and the full, separate minimum contribution.

Aggregate limit on contributions and benefits for key employees

The Act included additional rules with respect to the aggregate limit on benefits and contributions (sec. 415(e)) for a key employee who participates in both a defined benefit plan and a defined contribution plan that are included in a top-heavy group. Unless certain requirements are met, for any year for which the plans are included in the top-heavy group, the new defined benefit plan and defined contribution plan fractions are modified, effectively providing the key employee with an aggregate limit equal to the lesser of 1.0 (as applied only to the dollar limits) or 1.4 (as applied to the percentage limits).

These modifications do not apply if the plans of the employer in which the key employee participates (1) meet the requirements of the concentration test, and (2) provide either an extra minimum benefit (in the case of the defined benefit plan) or an extra minimum contribution (in the case of the defined contribution plan) for non-key employees participating in the plans. The extra contribution or benefit is nonintegrated and is in addition to the minimum contribution or benefit required for all top-heavy plans.

The concentration test is generally satisfied for a year if the plan is not more than 90 percent top heavy.

The requirement for an extra minimum benefit for non-key employees is satisfied for a year if, in addition to the minimum benefit otherwise required in a defined benefit plan, for the plan year ending with or within such year, the additional accrued benefit of each non-key employee who is a participant is not less than the lesser of (1) one percent of the employee's average annual compensation, multiplied by the employee's years of service with the employer, or (2) 10 percent of such average annual compensation. This extra minimum benefit generally is determined in the same manner as the minimum benefit required under the rules for a top-heavy defined benefit plan. However, for purposes of the extra minimum benefit, only certain years of service are required to be taken into account.

In a defined contribution plan, the requirement for an extra minimum contribution is satisfied for a year if, for the plan year ending with or within such year, the employer contributes on behalf of each non-key employee who is a participant an extra amount (in addition to the usual minimum contribution) that is not less than one percent of the employee's contribution for the year.

Distributions to key employees

TEFRA also provided new rules for distributions from top-heavy plans to key employees. If a distribution is made to an individual who is (or was) a key employee before he attains age 59-1/2, an additional income tax generally is imposed on that portion of the distribution attributable to accumulations or accruals made when he was a key employee in a top-heavy plan. The amount of the tax is equal to 10 percent of the amount includible in income, unless the distribution is made on account of death or disability.

In addition, a top-heavy plan must provide that distributions to an individual who is a key employee in a top-heavy plan at the time he attains age 70-1/2 will commence not later than the taxable year in which the key employee attains age 70-1/2, whether or not he separates from service in that year and whether or not he applies for benefit payments.

5. Organization performing management functions

TEFRA expanded the class of employees who are to be treated as employed by a single employer for purposes of certain of the tax-law rules for qualified pension, etc., plans (including the rules for top-heavy plans), cafeteria or medical reimbursement plans, or simplified employer pensions (SEPs). Under the provision, if an organization's principal business is performing, on a regular and continuing basis, management functions for one other organization, employees of both organizations are treated as employed by a single employer.

The present law rules relating to affiliated service organizations and to services historically performed by employees in the case of an affiliated service organization apply.

6. Employee leasing

The Act also provided that, for purposes of certain of the tax-law rules for qualified pension, etc., plans (including the rules for top-heavy plans) and SEPs, an individual (a leased employee) who performs services for another person (the recipient) is treated as the recipient's employee where the services are performed pursuant to an agreement between the recipient and a third person (the leasing organization) who is otherwise treated as the individual's employer. Under the provision, the individual is to be treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at least 12 months, and the services are of a type historically performed by employees in the recipient's business field. For this purpose, the prior-law rules relating to services historically performed by employees in the case of an affiliated service organization apply.

For purposes of determining whether a pension, etc., plan or a SEP maintained by the recipient satisfies the applicable tax-law requirements, the leased employee is treated as the recipient's employee for periods after the close of the 12-month period. However, the leased employee's years of service (sec. 411(a)) for the recipient are determined by taking into account the entire period for which the leased employee performed services for the recipient (or for a related person).

The Act also included a safe-harbor rule under which an individual who otherwise would be treated as a recipient's employee will not be treated as such an employee, if the leasing organization maintains a plan for its employees and that plan meets certain requirements with respect to vesting, contributions, and employee participation.

7. Certain corporations performing personal services

Under TEFRA, if a corporation, the principal activity of which is the performance of personal services substantially all of which are performed by employee-owners for or on behalf of another corporation, partnership, or entity (including related parties), is formed or availed of for the principal purpose of evasion or avoidance of Federal income tax by securing for any employee-owner significant tax benefits which would not otherwise be available, then the Secretary may allocate all income, as well as such deductions, credits, exclusions, etc., as may be allowable, between or among the corporation and employee-owners involved.

For this purpose, an employee-owner is defined as any employee who owns more than 10 percent of the outstanding stock of the corporation. The provision generally applies to taxable years beginning after December 31, 1982.

8. Disincorporation relief

TEFRA provided a transitional rule under which personal service corporations may complete, during 1983 or 1984, a one-month liquidation under section 333 of the Code without the risk that the corporation would incur tax on its unrealized receivables. Of course, the income represented by unrealized receivables will retain its character as ordinary income and will be fully recognized by the distributee shareholder upon subsequent collection or other disposition.

9. Group-term life insurance

TEFRA provided that the income exclusion for employer-provided group-term life insurance (sec. 79) will apply with respect to a key employee only if the life insurance is provided under a program of the employer that does not discriminate in favor of key employees as to (1) eligibility to participate, or (2) the life insurance benefits provided under the plan.

A program of an employer providing group-term life insurance for employees generally will not be considered to discriminate in favor of key employees as to eligibility to participate if (1) the program benefits at least 70 percent of all employees, (2) at least 85 percent of all participating employees are not key employees, or (3) the program benefits employees who qualify under a classification set up by the employer and found by the Secretary of the Treasury not to discriminate in favor of key employees. Alternatively, a program of an employer providing group-term life insurance which is provided under a cafeteria plan (sec. 125) will not be considered to discriminate in favor of key employees as to eligibility to participate if the eligibility rules for cafeteria plans are satisfied.

A program of an employer providing group-term life insurance for employees will not be considered to discriminate in favor of key employees as to the benefits provided, if the program does not discriminate in favor of such employees with regard to the type and amount of the benefits. For this purpose, group-term life insurance benefits will not be considered to discriminate merely because the amount of life insurance provided employees bears a uniform relationship to compensation. Of course, the requirement that group-term life insurance benefits be nondiscriminatory can be satisfied where, under the facts and circumstances, no discrimination in favor of key enmployees occurs. For example, the requirement would be satisfied when the life insurance benefits are a level dollar amount which is the same for all covered employees.

10. Effective dates

The provisions relating to parity between corporate and noncorporate employers, top-heavy plans, organizations performing management functions, employee leasing, and group-term life insurance apply to years beginning after December 31, 1983.

The provisions relating to certain corporations performing personal services apply to taxable years beginning after December 31, 1982.

D. Miscellaneous Pension Provisions (secs. 401, 403, and 415 of the Code and sec. 131 of the Revenue Act of 1978)

1. Retirement savings for church employees

TEFRA revised the prior law rules relating to tax-sheltered annuity programs maintained by churches for their employees by increasing the ability of churches to provide retirement income for their employees and by clarifying the status of such programs under the tax law.

2. Certain State judicial retirement plans

Under TEFRA, participants in a qualified State judicial plan are not subject to the rule requiring participants in a State deferred compensation plan that is not an eligible plan to include plan benefits in gross income when there is no substantial risk that the benefits will be forfeited (sec. 457(e)). A special definition is provided for a qualified State judicial plan. The provision applies to taxable years beginning after December 31, 1978.

3. Participation in group trusts by governmental plans

Under TEFRA, the tax-exempt status of a group trust is not adversely affected merely because the trust accepts monies from (a) a retirement plan of a State or local government, whether or not the plan is a qualified plan and whether or not the assets are held in trust, or (b) directly from a State or local government, if such monies are intended for use in satisfying an obligation of such State or local government to provide a retirement benefit under a governmental plan.

4. Contributions for disabled employees

TEFRA modified the limits on contributions and benefits under qualified plans, etc., to permit an employer to continue deductible contributions to a defined contribution plan on behalf of an employee who is permanently and totally disabled. For purposes of the limits, the compensation of a disabled employee is deemed to be equal to the annualized compensation of the employee prior to the employee's becoming disabled. However, the disabled employee must be fully and immediately vested in benefits derived from these contributions.