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PRESENT-LAW TAX RULES RELATING TO QUALIFIED PENSION PLANS

SCHEDULED FOR A HEARING

BEFORE THE

SUBCOMMITTEE ON PRIVATE RETIREMENT PLANS AND OVERSIGHT OF THE INTERNAL REVENUE SERVICE

OF THE

SENATE COMMITTEE ON FINANCE

ON MARCH 23, 1990

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

The Subcommittee on Private Retirement Plans and Oversight of the Internal Revenue Service of the Senate Committee on Finance has scheduled a public hearing on March 23, 1990, to review the Internal Revenue Code rules relating to private pension plans and possible options for simplification of pension plan rules.

This pamphlet,[1] prepared by the staff of the Joint Committee on Taxation, provides a discussion of issues relating to simplification of the Federal income tax rules relating to tax-qualified retirement plans. Part I of the pamphlet is a summary. This is followed by a description of the present-law Federal tax rules regarding tax-qualified plans (Part II), legislative background of the present-law rules (Part III), and a brief discussion of pension plan simplification issues (Part IV).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Present-Law Tax Rules Relating to Qualified Pension Plans* (JCS-9-90), March 22, 1990.

I. SUMMARY

A plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan) is accorded special tax treatment under present law. The employer maintaining the plan is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee is not required to include qualified plan benefits in income until the benefits are distributed from the plan. The purpose of the tax benefits for qualified plans is to encourage employers to establish nondiscriminatory retirement plans for their employees.

Qualified plans are broadly classified into two categories: defined contribution plans and defined benefit pension plans. There are several different types of defined contribution plans, including money purchase pension plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs).

The qualification standards and related rules governing qualified plans are generally designed to ensure that qualified plans benefit an employer's rank-and-file employees as well as the employer's highly compensated employees. They also define the rights of plan participants and beneficiaries and provide limits on the tax deferral possible under qualified plans.

The qualification rules include minimum participation rules that limit the age and service requirements an employer can impose as a requirement of participation in a plan; coverage and nondiscrimination rules designed to prevent qualified plans from discriminating in favor of highly compensated employees; vesting and accrual rules which limit the period of service an employer can require before an employee earns or becomes entitled to a benefit under a plan; limitations on the contributions and benefits of a plan participant; and minimum funding rules designed to ensure the solvency of defined benefit pension plans. The Code also contains rules regarding the taxation of qualified plan benefits; terminations of qualified plans; and rules designed to prevent plan fiduciaries and others closely associated with a plan from misusing plan assets.

The present-law rules governing qualified plans originated in the Employee Retirement Income Security Act of 1974 (ERISA). ERISA forms the basis for the current private pension system. The rules enacted in ERISA have been revised several times. The most comprehensive revision to the qualification rules since the enactment of ERISA was made by the Tax Reform Act of 1986.

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. There are several sources for this complexity, including the interaction of retirement policy and tax policy, the volume and frequency of employee benefits legislation, the structure of the workplace, the need to provide

employers and employees flexibility in tailoring compensation packages, the desire for certainty in the law, and transition rules.

In analyzing any proposal to simplify the pension rules, the following issues are important: (1) the extent to which the proposed change is consistent with the underlying policy objectives of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and grandfather rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

II. PRESENT-LAW RULES [2]

A. Overview of Qualified Plans

In general

A plan of deferred compensation that meets the qualificatio standards of the Internal Revenue Code (a qualified plan), is ac corded special tax treatment under present law. Employees do no include qualified plan benefits in gross income until the benefit are distributed even though the plan is funded and the benefits ar nonforfeitable. Tax deferral is provided under qualified plans fron the time contributions are made until the time benefits are re ceived. The employer is entitled to a current deduction (withi limits) for contributions to a qualified plan even though an employ ee's income inclusion is deferred. Contributions to a qualified pla are held in a tax-exempt trust.

The special tax benefits for qualified plans and qualified pla benefits represent a significant tax expenditure. For fiscal yea 1991, the tax expenditure for the net exclusion for pension contri butions and earnings is estimated to be $52.2 billion.[3]

The policy rationale for this tax expenditure is that the tax bene fits for qualified plans encourage employers to provide retiremen benefits for their employees. This reduces the need for public as sistance and reduces pressure on the social security system.

The qualification standards and related rules governing qualifie plans are designed to ensure that qualified plans benefit an em ployer's rank-and-file employees as well as highly compensated em ployees. They also define the rights of plan participants and benefi ciaries and provide some limit on the tax benefits for qualifie plans.

Types of qualified plans

Defined benefit pension plans and defined contribution plan

Qualified plans are broadly classified into two categories: define contribution plans and defined benefit pension plans, based on th nature of the benefits provided.

Under a defined benefit pension plan, benefit levels are specifie under a plan formula. For example, a defined benefit pension pla might provide a monthly benefit of $10 for each year of servic

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[2] This pamphlet is limited to a discussion of the Internal Revenue Code rules relating to ta qualified retirement plans. In addition to the rules in the Internal Revenue Code, the labor la provisions of the Employee Retirement Income Security Act of 1974 (ERISA) contain extensiv rules regarding employee benefit pension plans. A discussion of the labor law provisions i beyond the scope of this pamphlet. This pamphlet also does not discuss other types of employe sponsored tax-favored retirement programs such as tax-sheltered annuities (sec. 403(b)) or sim plified employee pensions (sec. 408(k)).

[3] *See* Joint Committee on Taxation, *Estimates of Federal Tax Expenditures for Fiscal Year 1991-1995* (JCS-7-90), March 9, 1990.

completed by an employee. Benefits under a defined benefit pension plan also may be specified as a flat or step-rate percentage of the employee's average compensation or career compensation. Benefits under a defined benefit pension plan are funded by the general assets of the trust established under the plan; individual accounts are not maintained for employees participating in the plan.[4]

Benefits under a defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC) (a Federal corporation within the Department of Labor).

Benefits under defined contribution plans are based solely on the contributions (and earnings thereon) allocated to separate accounts maintained for each plan participant. There are several different types of defined contribution plans, including money purchase pension plans, target benefit plans, profit-sharing plans, stock bonus plans, and employee stock ownership plans (ESOPs). The various different types of plans are in part historical and reflect the various different ways in which employers structure deferred compensation programs for their employees.

Money purchase pension plans and target benefit plans

Under a money purchase pension plan, the amount of employer contributions allocated to the account of an employee must be fixed or determinable from a formula set forth in the plan. Under a target benefit plan, contributions are determined on an actuarial basis in an attempt to provide the participant with a specified level of retirement benefit. Although money purchase pension plans and target benefit plans are defined contribution plans, many of the qualification rules applicable to defined benefit plans also apply to such plans. For example, benefits may be paid under a defined benefit pension plan or a money purchase pension plan only in the event of death, disability, separation from service, or attainment of normal retirement age.

Profit-sharing and stock bonus plans

Under a profit-sharing plan, employer contributions are generally provided out of current or accumulated profits of the employer. Profit-sharing plans are not required to specify a contribution rate or formula; the amount of contributions may be determined at the discretion of the employer. Stock bonus plans are similar to profit-sharing plans, except that they are generally designed to provide benefits in the form of employer stock. Under a profit-sharing or stock bonus plan, benefits can generally be distributed to an employee who has not separated from service provided the amounts distributed have been in the plan for at least 2 years.

A profit-sharing or stock bonus plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments (e.g., a portion of current salary) directly to the employee in cash or as contributions to a qualified plan on behalf of the employee. Qualified cash or deferred arrangements are subject to special rules. For 1990, elective deferrals under a qualified cash or deferred arrange-

[4] Individual accounts may be maintained for after-tax employee contributions made to a defined benefit pension plan.

ment are limited to $7,979 per individual. This limitation is increased annually for inflation.

Employee stock ownership plans

An ESOP is a qualified stock bonus plan or a combination of a stock bonus plan and money purchase pension plan that is designed to invest primarily in employer securities and that meets certain other requirements.

ESOPs have the unique ability to acquire employer securities by borrowing from the employer maintaining the plan or with a loan guaranteed by the employer. An ESOP that borrows to acquire employer securities is referred to as a leveraged ESOP. For example, in a typical ESOP leveraging transaction a corporation borrows from a bank or other financial institution and then relends the funds to an ESOP, which uses them to acquire employer securities. The employer makes contributions to the ESOP which are used to retire the debt. Because of this unique leveraging ability, ESOPs are often used as a device for capital formation as well as an employee benefit program.

ESOPs are subject to rules not applicable to other types of qualified plans. In addition, ESOPs receive special tax benefits not available to other types of qualified plans. For example, the deduction limits for leveraged ESOPs are higher than the deduction limits applicable to other types of defined contribution plans; a bank or other financial institution lending money to an ESOP can exclude from income 50 percent of the interest received on the loan if the ESOP owns more than 50 percent of the stock of the employer and certain other requirements are satisfied (sec. 133); in certain circumstances, an individual who sells employer securities to an ESOP can defer recognition of gain on the sale (sec. 1042); and an employer may deduct certain dividends paid on employer securities held by an ESOP (sec. 404(k)).

Sanction for failure to meet qualification rules

If a plan fails to meet the qualification standards, then the special tax benefits for qualified plans do not apply, and benefits and contributions are taxed under normal income tax rules. In general, if a plan fails to meet the qualification standards, then contributions to the plan are includible in employees' gross income when such contributions are no longer subject to a substantial risk of forfeiture (secs. 402(b) and 83). Amounts actually distributed or made available to an employee are generally includible in income in the year distributed or made available under the rules applicable to taxation of annuities (sec. 72). Special sanctions (described below) apply in the case of failure to meet certain qualification rules.

An employer is generally not entitled to a deduction for contributions to a nonqualified plan until the contributions are includible in an employee's gross income.

B. Plan Qualification Requirements

1. Minimum participation standards

In general

Under present law, a qualified plan must satisfy certain minimum standards relating to the conditions under which employees may be excluded from plan participation (sec. 410(a)). A qualified plan generally may not require an employee to complete more than one year of service or attain an age greater than 21 as a condition of plan participation. A plan may require 2 years of service prior to an employee becoming eligible to participate if an employee's accrued benefit becomes 100 percent vested immediately upon his or her admission to the plan.

Determining years of service [5]

For purposes of the participation requirements, the term "year of service" generally means a consecutive 12-month period during which an employee has worked at least 1,000 hours. Detailed rules for counting hours of service and alternative methods of measuring service are set forth in Treasury and Department of Labor regulations.

In general, all years of service with the employer maintaining a plan are taken into account for purposes of the minimum participation requirements. No credit need be provided however, for periods during which an employee is considered to have a break in service. In some cases, an employee who returns to work for an employer after a break in service may lose credit for pre-break service, and therefore may be required to satisfy again the plan's participation requirement before being readmitted to the plan.

A plan may provide that a 1-year break in service occurs in a 12-month measuring period in which the employee does not complete more than 500 hours of service. A plan may provide that an employee who completes more than 500 hours of service but fewer than 1,000 hours of service has neither a 1-year break in service nor a year of service for participation purposes.

A plan may provide that years of service before a 1-year break in service are not taken into account until after the employee completes a post-break year of service. If the plan has a 2-year participation requirement and an employee has a 1-year break in service before satisfying such requirement, then service before the break may be disregarded.

In the case of a nonvested participant, years of service with the employer before any period of consecutive 1-year breaks in service are required to be taken into account after a break in service unless the number of consecutive 1-year breaks in service equals or exceeds the greater of (1) 5 years or (2) the aggregate number of years of service before the consecutive 1-year breaks in service. If any years of service are not required to be taken into account by reason of a period of breaks in service under this rule, then those

[5] Similar rules regarding counting years of service also apply under the vesting rules (discussed at 3.a., below).

years of service are not required to be taken into account if there is a subsequent break in service.

For purposes of determining whether a break in service has occurred an individual is deemed to have completed hours of service during certain periods of absence from work for maternity or paternity reasons. This rule applies to an individual who is absent from work (1) by reason of the pregnancy of the individual, (2) by reason of the birth of a child of the individual, (3) by reason of the placement of a child in connection with the adoption of the child by the individual, or (4) for purposes of caring for the child during the period immediately following the birth or placement for adoption.

During an absence for maternity or paternity reasons, the individual is treated as having completed (1) the number of hours that normally would have been credited but for the absence, or (2) if the normal work hours are not known, 8 hours of service for each normal workday during the leave (whether or not approved). The total number of hours of service required to be treated as completed is 501 hours.

2. Coverage and nondiscrimination requirements

Key among the qualification standards are coverage and nondiscrimination rules designed to ensure that qualified plans benefit a significant number of an employer's rank-and-file employees as well as highly compensated employees. These rules include numerical minimum coverage rules (sec. 410(b)), a minimum participation rule requiring that a plan benefit a minimum number of employees (sec. 401(a)(26)), and a general nondiscrimination requirement (sec. 401(a)(4)). Special nondiscrimination rules apply to qualified cash or deferred arrangements, employer matching contributions, and after-tax employee contributions.

a. Minimum coverage rules

In general

A plan is not qualified unless the plan satisfies at least one of the following coverage requirements:

(1) the plan benefits at least 70 percent of all an employer's nonhighly compensated employees (the "percentage test");

(2) the plan benefits a percentage of nonhighly compensated employees that is at least 70 percent of the percentage of highly compensated employees benefiting under the plan (the "ratio test"); or

(3) the plan meets the average benefits test.

A plan maintained by an employer that has no nonhighly compensated employees is deemed to satisfy the coverage requirements. A plan that benefits only nonhighly compensated employees will also automatically satisfy the minimum coverage requirements.

The coverage rules may be applied separately to each separate line of business of the employer. (The definition of a line of business is discussed below.) Present law contains a special rule for application of the coverage rules in the event of dispositions or acquisitions and other corporate transactions. These rules are designed to provide a transition period during which the transaction will not result in a failure to satisfy the rules.

Average benefits test

A plan meets the average benefits test if (1) the plan benefits such employees as qualify under a classification set up by the employer and found by the Secretary of the Treasury not to be discriminatory in favor of highly compensated employees ("classification test"); and (2) the average benefit percentage for nonhighly compensated employees of the employer is at least 70 percent of the average benefit percentage for highly compensated employees of the employer.

The term "average benefit percentage" means, with respect to any group of employees, the average of the benefit percentages calculated separately with respect to each employee in such group. The term "benefit percentage" means the employer-provided contributions (including forfeitures) or benefits of an employee under all qualified plans of the employer, expressed as a percentage of such employee's compensation.

For purposes of determining benefit percentages, all pre-tax contributions or benefits provided under a qualified plan are considered employer-provided and are to be taken into account, including, for example, elective deferrals under a qualified cash or deferred arrangement (sec. 401(k)). In no case may an employer disregard any qualified plan in determining benefit percentages, even if such qualified plan satisfies the percentage test or ratio test standing alone. Contributions or benefits under other types of tax-favored retirement plans other than qualified plans (such as simplified employee pension plans (sec. 408(k)) or tax-sheltered annuity programs (sec. 403(b)) are not taken into account.

After the benefit percentage of each employee is determined in the manner described above, the average for the 2 groups (highly compensated employees and nonhighly compensated employees) is then determined by averaging the individual benefit percentages of each employee (including employees not covered by any qualified plan).

Employees benefiting under the plan

For purposes of the coverage rules, an employee generally will be treated as benefiting under the plan only if the employee is a participant with respect to whom the plan benefit accrues or, in the case of a defined contribution plan, is contributed. However, in the case of a qualified cash or deferred arrangement or the portion of a defined contribution plan to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive (as applicable) contributions under the plan.

However, for purposes of the average benefit percentage component of the average benefits test, it is actual benefits and contributions, not eligibility, that is taken into account with respect to all types of plans.

Aggregation of plans and comparability

For purposes of applying the percentage test or the ratio test, an employer may designate more than 1 plan as a single plan and test the plans as a unit if the plans provide comparable benefits or con-

tributions. Also, for purposes of satisfying the average benefits test, 2 or more comparable plans may be aggregated for purposes of determining whether the plans together satisfy the classification test. The determination of whether a group of plans is comparable is made in accordance with Treasury regulations, and is based on the relevant facts and circumstances.[6]

Excluded employees

For purposes of determining whether a plan satisfies the coverage rules, the employer generally is to exclude from consideration the following classes of employees: (1) employees who have not met the plan's minimum age or service requirements; (2) for purposes of applying the minimum coverage rules to qualified plan coverage of employees who are not included in a unit of employees covered by a collective bargaining agreement, employees not covered by the agreement; and (3) nonresident aliens with no United States source earned income.

Sanction

A special sanction applies to violations of the minimum coverage rules. Under this sanction, if one of the reasons a plan fails to be a qualified plan is because it fails either the coverage rules or the minimum participation rule, described below, then highly compensated employees are to include in income the value of their vested accrued benefit as of the close of the year in which the plan fails to qualify. Nonhighly compensated employees are not taxed on their benefits if the only reason a plan is not a qualified plan is a failure to satisfy the coverage requirements or the minimum participation rule.

b. Minimum participation rule

A plan is not a qualified plan unless it benefits no fewer than the lesser of (a) 50 employees of the employer or (b) 40 percent of all employees of the employer (sec. 401(a)(26)). This requirement may not be satisfied by aggregating comparable plans, but may be applied separately to different lines of business of the employer. In the case of a cash or deferred arrangement or the portion of a defined contribution plan (including the portion of a defined benefit plan treated as a defined contribution plan (sec. 414(k)) to which employee contributions or employer matching contributions are made, an employee will be treated as benefiting under the plan if the employee is eligible to make or receive contributions under the plan.

The minimum participation rule was enacted because the Congress determined that it was inappropriate to permit an employer to maintain multiple plans, each of which covered a very small number of employees. Although plans that are aggregated for cov-

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[6] As part of the Tax Reform Act of 1986, Congress directed the Secretary to issue new guidance relating to comparability. Under prior law, Rev. Rul. 81-202, 1981-2 C.B. 93, provided guidance for determining whether the amount of employer-derived benefits or contributions provided under several plans discriminated in favor of highly compensated employees. That ruling provided (1) methods for adjusting all types of benefits to a standard form; (2) methods for converting benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits.

erage purposes are required to be comparable, plans could be considered comparable and still be discriminatory because the comparability rules do not look at all plan features. Moreover, the Congress was concerned that because of the large number of these arrangements, the inherent complexity of comparability analysis, and the difficulties in discovering all differences in plan benefits, the IRS lacked sufficient resources to monitor compliance with the nondiscrimination rules by small aggregated plans.

The Secretary of the Treasury is authorized to provide that any separate benefit structure, any separate trust, or any separate arrangement with respect to a plan may be treated as a separate plan for purposes of applying the minimum participation rule. Thus, for example, a plan that provides 2 different formulas for calculating participants' benefits or contributions may be treated as at least 2 plans.

For purposes of applying the minimum participation rules, the same categories of employees may be disregarded as are disregarded for purposes of applying the minimum coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such unit may be disregarded for purposes of satisfying the minimum participation rule. This exception does not apply to any collectively bargained plan that covers any professional (e.g., a doctor, lawyer, or investment banker).

The minimum participation rule generally does not apply to a multiemployer plan. However, this exemption does not apply to a multiemployer plan that covers any professional (e.g., a doctor, lawyer, or investment banker). Special rules also apply to plans for police and firefighters and in the case of dispositions and acquisitions and similar corporate transactions.

The special sanction that applies for failure to satisfy the minimum coverage rules (described above) also applies to failures to satisfy the minimum participation rule.

c. Nondiscrimination in contributions or benefits

A qualified plan may not discriminate in favor of highly compensated employees with respect to contributions or benefits under the plan (sec. 401(a)(4)). This general nondiscrimination requirement applies to all plan aspects, including those not addressed under the numerical tests. Thus, it may apply not only with respect to contributions or benefits, but also with respect to optional forms of benefit and other benefits, rights, and plan features such as actuarial assumptions, rates of accrual methods of benefit calculation, loans, social security supplements, and disability benefits.

Whether or not a plan meets the general nondiscrimination test is a factual determination, based on the relevant facts and circumstances. A plan does not fail to meet the general nondiscrimination test merely because contributions or benefits bear a uniform relationship to compensation.

d. Application of nondiscrimination rules to integrated plans

In general

Under present law, a qualified plan may be "integrated" with social security. That is, a plan may adjust benefits under the plan to take into account social security benefits. A plan that does so will generally provide greater benefits for highly compensated employees than nonhighly compensated employees, because social security does not provide complete wage replacement for more highly compensated employees. Present law provides that such a plan is not discriminatory under the general nondiscrimination rule merely because the contributions and benefits under the plan favor highly compensated employees, if the disparity between contributions or benefits for highly and nonhighly compensated employees meets certain requirements (sec. 401(l)). In addition, an integrated plan is required to provide that benefits may be distributed only upon retirement, death, disability, or other separation from service.

Permitted disparity in defined contribution plans

A defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage (i.e., the contribution by the employer with respect to compensation over the integration level, expressed as a percentage of compensation) does not exceed the base contribution percentage (i.e., the contribution by the employer with respect to compensation up to the integration level, expressed as a percentage of such compensation) by more than the lesser of (1) the base contribution percentage, or (2) the greater of 5.7 percentage points or the percentage equal to the portion of the rate of tax in effect attributable to old-age insurance as of the beginning of the plan year (sec. 3111(a)).

A plan is required to specify the applicable integration level for a year. The maximum integration level permitted for a year, however, is the OASDI contribution and benefit base under social security (taxable wage base) in effect at the beginning of the year ($51,300 for 1990).

Permitted disparity in defined benefit pension plans

There are two basic approaches to integrating defined benefit pension plans: the excess approach and the offset approach.

Excess plans.—An excess plan is a plan under which benefits are provided at one or more specified rates below the plan's integration level and at other higher rates above that level. The excess benefit percentage (i.e., benefits provided by the employer with respect to compensation in excess of the applicable integration level, expressed as a percentage of compensation) under a defined benefit excess plan may not exceed the base benefit percentage (i.e., benefits provided by the employer with respect to compensation not in excess of such integration level, expressed as a percentage of such compensation) by more than the maximum excess allowance.

In the case of an excess plan, the maximum excess allowance with respect to benefits attributable to any year of service taken into account under the plan is the lesser of (1) the base benefit percentage, or (2) 3/4 of a percentage point. The maximum excess allowance for such a plan with respect to total benefits is the lesser

of (1) the base benefit percentage, or (2) 3/4 of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan.

Offset plans.—The term "offset plan" means any defined benefit pension plan under which the employer-provided benefit for each participant is reduced by an amount specified in the plan. In the case of a defined benefit offset plan, a participant's accrued benefit may not be reduced by reason of the offset by more than the maximum offset allowance for such participant. The maximum offset allowance with respect to a participant for any year of service taken into account under the plan is the lesser of (1) 50 percent of the benefit that would have accrued without regard to the offset reduction, or (2) 3/4 percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan. For purposes of this allowance, a participant's final average compensation is calculated by disregarding compensation in any year over the social security taxable wage base for such year.

The Secretary is to reduce the 3/4 percent factor in the maximum excess and maximum offset allowances for certain plans providing for unreduced benefits (other than for disability, as defined under the Social Security Act) commencing before the social security retirement age.

e. Nondiscrimination rules relating to qualified cash or deferred arrangements

In general

A profit-sharing or stock bonus plan, a pre-ERISA money purchase pension plan, or a rural cooperative plan may include a qualified cash or deferred arrangement (sec. 401(k)). Under such an arrangement, an employee may elect to have the employer make payments as contributions to a plan on behalf of the employee, or to the employee directly in cash. Contributions made at the election of the employee are called elective deferrals. Several special rules apply to cash or deferred arrangements.

As discussed above, a qualified plan generally cannot provide greater benefits to highly compensated employees. The integration rules provide one exception to this rule. Another exception is provided in the case of qualified cash or deferred arrangements. Under a special nondiscrimination test, the benefits provided to highly compensated employees under a cash or deferred arrangement can be a multiple of the benefits provided to nonhighly compensated employees.

The nondiscrimination test applicable to elective deferrals under qualified cash or deferred arrangements is satisfied if the actual deferral percentage for eligible highly compensated employees for a plan year is equal to or less than either (1) 125 percent of the actual deferral percentage of all nonhighly compensated employees eligible to defer under the arrangement, or (2) the lesser of 200 percent of the actual deferral percentage of all eligible nonhighly compensated employees or the actual deferral percentage for all eligible nonhighly compensated employees plus 2 percentage points. The actual deferral percentage for a group of employees is the av-

erage of the ratios (calculated separately for each employee in the group) of the contributions paid to the plan on behalf of the employee to the employee's compensation.

If a cash or deferred arrangement satisfies the special nondiscrimination test, it is treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of elective deferrals. However, the group of employees eligible to participate in the arrangement is still required to satisfy the minimum coverage tests (sec. 410(b)).

Under Treasury regulations, employer matching contributions that meet the vesting and withdrawal restrictions applicable to elective deferrals (discussed below) under a qualified cash or deferred arrangement, and qualified nonelective contributions may be taken into account in determining actual deferral percentages. Qualified nonelective contributions are defined to mean employer contributions (other than matching contributions) with respect to which (1) the employee may not elect to have the contributions paid to the employee in cash or other benefits in lieu of being contributed to the plan and (2) the vesting and withdrawal restrictions applicable to elective deferrals under a qualified cash or deferred arrangement are satisfied. Employer matching contributions and qualified nonelective contributions do not meet the applicable withdrawal restrictions if such contributions (or earnings thereon) may be distributed on account of hardship.

Excess contributions

If the special nondiscrimination rules are not satisfied for any year, the qualified cash or deferred arrangement will not be disqualified if the excess contributions (plus income allocable to the excess contributions) are distributed before the close of the following plan year. In addition, under Treasury regulations, instead of receiving an actual distribution of excess contributions, an employee may elect to have the excess contributions treated as an amount distributed to the employee and then contributed by the employee to the plan on an after-tax basis.

The amount distributed is not subject to the 10-percent additional income tax on early withdrawals (sec. 72(t)), the 15-percent tax on excess distributions (sec. 4980A), or the 10-percent tax on nondeductible contributions (sec. 4972) (see below).

Excess contributions mean, with respect to any plan year, the excess of the aggregate amount of elective deferrals paid to the cash or deferred arrangement and allocated to the accounts of highly compensated employees over the maximum amount of elective deferrals that could be allocated to the accounts of highly compensated employees without violating the nondiscrimination requirements applicable to the arrangement. To determine the amount of excess contributions and the employees to whom the excess contributions are to be distributed, the elective deferrals of highly compensated employees are reduced in the order of their actual deferral percentages beginning with those highly compensated employees with the highest actual deferral percentages. The excess contributions are to be distributed to those highly compensated employees for whom a reduction is made under the preceding sentence in order to satisfy the special nondiscrimination test.

Excise tax on excess contributions

An excise tax is imposed on the employer making excess contributions to a qualified cash or deferred arrangement (sec. 4979). The tax is equal to 10 percent of the excess contributions (but not earnings on those contributions) under the arrangement for the plan year ending in the taxable year. However, the tax does not apply to any excess contributions that, together with income allocable to the excess contributions, are distributed or, in accordance with Treasury regulations, recharacterized as after-tax employee contributions no later than 2-½ months after the close of the plan year to which the excess contributions relate.

Excess contributions (plus income) distributed or recharacterized within the applicable 2-½-month period are to be treated as received and earned by the employee in the employee's taxable year in which the excess contributions, but for the employee's deferral election, would have been received as cash. For purposes of determining the employee's taxable year in which the excess contributions are includible in income, the excess contributions are treated as the first contributions made for a plan year. Of course, distributions of excess contributions (plus income) within the applicable 2-½-month period are not taxed a second time in the year of distribution.

f. Nondiscrimination rules relating to employer matching contributions and employee contributions

In general

A special nondiscrimination test is applied to employer matching contributions and employee contributions under qualified defined contribution plans (sec. 401(m)).[7] This special nondiscrimination test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements. Contributions which satisfy the special nondiscrimination test are treated as satisfying the general nondiscrimination rules (sec. 401(a)(4)) with respect to the amount of contributions.

The term "employer matching contributions" means any employer contribution made on account of (1) an employee contribution or (2) an elective deferral under a qualified cash or deferred arrangement. Employer matching contributions that are treated as elective deferrals for purposes of the special nondiscrimination test applicable to cash or deferred arrangements are not subject to the special test applicable to matching contributions and employee contributions, unless the employer elects otherwise.

The special nondiscrimination test is satisfied for a plan year if the contribution percentage for eligible highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees, or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees, or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in

[7] These rules also apply to certain employee contributions to a defined benefit pension plan.

the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

Required aggregation

If 2 or more plans of an employer to which matching contributions, employee contributions, or elective deferrals are made are treated as a single plan for purposes of the coverage requirements for qualified plans (sec. 410(b)), then the plans are treated as a single plan for purposes of the special nondiscrimination test. In addition, if a highly compensated employee participates in 2 or more plans of an employer to which contributions subject to the special nondiscrimination test are made, then all such contributions made on behalf of the highly compensated employee are aggregated for purposes of the special nondiscrimination test.

Permissive aggregation

Under Treasury regulations, an employer may elect to take into account elective deferrals, matching contributions treated as elective deferrals, and/or qualified nonelective contributions under the plan or under any other plan of the employer.

Elective deferrals, matching contributions treated as elective deferrals, or qualified nonelective contributions may only be taken into account for purposes of the special nondiscrimination rules if the deferrals or contributions taken into account satisfy the applicable nondiscrimination rules and other contributions would not fail to satisfy applicable nondiscrimination rules if the deferrals or contributions taken into account were disregarded.

Treatment of excess aggregate contributions

As under the rules relating to qualified cash or deferred arrangements, if the special nondiscrimination test is not satisfied for any year, the plan will not be disqualified if the excess aggregate contributions (plus income allocable to such excess aggregate contributions) are distributed before the close of the following plan year. Generally, the amount of excess aggregate contributions and their allocation to highly compensated employees is determined in the same manner as with respect to excess contributions.

Distribution of excess aggregate contributions may be made notwithstanding any other provision of law, and the amount distributed is not subject to the additional income tax on early withdrawals (sec. 72(t)) or the 15-percent tax on excess distributions (sec. 4980A). Contributions are not subject to the 10-percent tax on nondeductible contributions (sec. 4972) merely because they are excess aggregate contributions.

A plan may designate whether excess contributions or excess aggregate contributions are attributable to elective deferrals, qualified nonelective contributions, employee contributions, or employer matching contributions, as long as the ordering designated by the plan is used consistently. A plan may not designate an order of distributions that results in the plan violating the general nondiscrimination requirements (sec. 401(a)(4)).

Excise tax on excess aggregate contributions

An excise tax is imposed on the employer with respect to excess aggregate contributions (sec. 4979). The tax is equal to 10 percent of the excess aggregate contributions (but not earnings on those contributions) under the plan for the plan year ending in the taxable year.

However, the tax does not apply to any excess aggregate contributions that, together with income allocable to the excess aggregate contributions, are distributed (or, if nonvested, forfeited) no later than 2-½ months after the close of the plan year in which the excess aggregate contributions arose.

Excess matching contributions (plus income), excess elective deferrals (plus income), excess qualified nonelective contributions (plus income) and income on excess employee contributions distributed within the applicable 2-½ month period are to be treated as received and earned by the employee in the employee's taxable year to which such excess aggregate contributions relate. Excess matching contributions are deemed to relate to the same taxable year to which the employee's mandatory contribution relates, i.e., mandatory contributions that are elective deferrals relate to the taxable year in which the employee would have received (but for the deferral election) the deferral as cash, and mandatory contributions that are employee contributions relate to the taxable year of contribution. For purposes of this rule, the first contributions (of the type distributed) for a plan year are deemed to be excess aggregate contributions.

g. Limit on includible compensation

A limit is provided with respect to the amount of a participant's compensation that can be taken into account under a qualified plan (sec. 401(a)(17)). This limit on includible compensation is $209,200 for 1990, and is adjusted annually for inflation. The limit applies for most rules relating to qualified plans, including the general nondiscrimination rules and the special rules for qualified cash or deferred arrangements, matching contributions, and employee contributions.

3. Vesting and accrual rules

a. Vesting requirements

In general

A plan is not a qualified plan (except in the case of a multiemployer plan) unless a participant's employer-provided benefit vests at least as rapidly as under 1 of 2 alternative minimum vesting schedules (sec. 411(a)). Vesting occurs when a participant acquires a nonforfeitable right to a benefit.

A plan satisfies the first schedule if a participant has a nonforfeitable right to 100 percent of the participant's accrued benefit derived from employer contributions upon the participant's completion of 5 years of service. A plan satisfies the second schedule if a participant has a nonforfeitable right to at least 20 percent of the participant's accrued benefit derived from employer contributions after 3 years of service, 40 percent at the end of 4 years of service,

60 percent at the end of 5 years of service, 80 percent at the end of 6 years of service, and 100 percent at the end of 7 years of service. Separate rules apply to top-heavy plans (discussed below).

Multiemployer plans

In the case of a multiemployer plan, a participant's accrued benefit derived from employer contributions is required to be 100 percent vested no later than upon the participant's completion of 10 years of service. This exception applies only to employees covered by the plan pursuant to a collective bargaining agreement.

Minimum period of service

As discussed above, a plan may require, as a condition of participation, that an employee complete a period of service with the employer of no more than 2 years. However, a plan that requires that an employee complete more than 1 year of service as a condition of participation is also required to provide that each participant in the plan has a nonforfeitable right to 100 percent of the participant's accrued benefit under the plan as the benefit is accrued.

Cash or deferred arrangements; employee contributions

Elective deferrals under a qualified cash or deferred arrangement and after-tax employee contributions are required to be nonforfeitable when made.

Changes in vesting schedule

If a plan's vesting schedule is modified by a plan amendment, the plan will not be qualified unless each participant with at least 3 years of service is permitted to elect, within a reasonable period after the adoption of the amendment, to have the nonforfeitable percentage of the participant's accrued benefit computed without regard to the plan amendment.

Years of service

In general, the same rules regarding years of service, breaks in service, and absences due to maternity and paternity that apply for purposes of the minimum participation requirements also apply for vesting purposes. In addition, the following periods of service are not required to be taken into account for vesting purposes: (1) years of service before age 18, (2) years of service during which the employee failed to make required contributions to the plan, and (3) years of service during which the employer did not maintain the plan (or a predecessor plan). A special break in service rule applies for vesting purposes to defined contribution plans. Under this rule, if a participant in such a plan has 5 consecutive 1-year breaks in service, years of service after such break are not required to be taken into account in calculating, the vested portion of benefits accrued before such 5-year period.

b. Rate of accrual requirements

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue (i.e., earn) benefits at a rate that meets one of 3 alternative schedules (sec. 411(b)). The pur-

pose of these schedules generally is to limit the extent to which an employer may defer (i.e., "backload") benefit accruals.

Under the first alternative, known as the "3-percent rule," a plan participant must accrue a benefit during each year of participation (up to 33-⅓ years) of not less than 3 percent of a specified benefit amount. The specified benefit amount is the benefit to which an employee who entered the plan at the earliest entry age and participated until the earlier of normal retirement age or age 65 would otherwise be entitled.

Under the second alternative, known as the "133-⅓-percent rule," a plan will satisfy the accrued benefit requirements if the accrued benefit of a plan participant, as of his or her normal retirement age, is equal to the normal retirement benefit under the plan and the annual rate at which any plan participant accruing the retirement benefits in any year, is never more than 133-⅓ percent of the annual accrual rate for any prior year.

Under the third alternative, known as the "fractional rule," each plan participant's accrued benefit at the end of any year must be at least equal to a fractional portion of the retirement benefit to which the participant would be entitled under the plan's benefit formula if the participant continued to earn the same rate of compensation annually until normal retirement age. The fractional portion is determined by dividing the plan participant's actual years of participation by the total number of years of participation that would have been completed if the participant had continued in service until normal retirement age.

4. Limitations on contributions and benefits

In general

Under present law, overall limits are provided on contributions and benefits under qualified plans (sec. 415). The overall limits apply to all such contributions and benefits provided to an individual by any private or public employer.

Defined contribution plans

Under a defined contribution plan, the qualification rules limit the annual additions to the plan with respect to each plan participant to the lesser of (1) 25 percent of compensation or (2) $30,000 (sec. 415(c)). Annual additions are the sum of employer contributions, employee contributions, and forfeitures with respect to an individual under all defined contribution plans of the same employer. The $30,000 limit will be increased when $30,000 is less than one-fourth of the dollar limit on benefits under a defined benefit pension plan (see below).

Defined benefit pension plans

In general

Under present law, the limit on the annual benefit payable by a defined benefit pension plan is generally the lesser of (1) 100 per-

cent of average compensation, or (2) $102,582, for 1990 (sec. 415(b)).[8] The dollar limit is adjusted annually for cost-of-living increases. The dollar limit is reduced proportionately for individuals with less than 10 years of participation in the plan.

The dollar limit on annual benefits is reduced if benefits under the plan begin before the social security retirement age so that the limit is actuarially equivalent to a benefit beginning at the social security retirement age. The actuarial reduction is computed using an assumed interest rate that is not less than the greater of 5 percent or the rate specified in the plan.

If retirement benefits provided by a defined benefit pension plan begin after the social security retirement age, the dollar limit is increased so that it is the actuarial equivalent of the dollar limit applicable to a benefit beginning at the social security retirement age. The increase is to be computed using an interest rate assumption not higher than the lesser of 5 percent or the rate specified in the plan.

Present law provides that a minimum benefit can be paid even if the benefit exceeds the normally applicable benefit limitations. Thus, the overall limits on benefits are deemed to be satisfied if the retirement benefit of a participant under all defined benefit pension plans of the employer does not exceed $10,000 for a year or any prior year, and the participant has not participated in a defined contribution plan of the employer. The $10,000 limit is reduced for participants with less than 10 years of participation in the plan.

Special rules for plans of State and local governments

Special rules apply to State and local governmental plan. For those plans, the rules in effect prior to the Tax Reform Act of 1986 apply with respect to the limits on annual benefits.[9] Accordingly, the actuarial reduction of the dollar limit on annual benefits for early retirement does not reduce the limit (1) for benefits commencing on or after the participant has attained age 62 (rather than the social security retirement age), (2) below $75,000 for benefits commencing on or after the participant has attained age 55, or (3) below the actuarial equivalent of $75,000 payable at age 55, for benefits commencing before age 55.

Present law also contains a special rule that permits a plan maintained by a State or local government to provide benefits to qualified participants equal to the accrued benefit of the participant (without regard to any benefit increases pursuant to a plan amendment adopted after October 14, 1987) even though such benefit exceeds the otherwise applicable limits on benefits. A qualified participant is a participant who first became a participant in the plan before January 1, 1990.

The special rule does not apply unless the employer elects, by the close of the first plan year beginning after December 31, 1989, to

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[8] Annual benefits may in some cases exceed this dollar limitation under grandfather and transition rules contained in the Tax Equity and Fiscal Responsibility Act of 1982 and other legislation.

[9] These rules also apply to plans maintained by nongovernmental tax exempt organizations and qualified merchant marine plans. Certain other special rules apply to church plans, airline pilots, and police and firefighters.

have the normal limits on contributions and benefits apply to all plan participants other than qualified participants.

This special rule was enacted out of recognition that some governmental plans did not conform to the limit on contributions and benefits due to State constitutional prohibitions on impairment of contracts. The special rule was designed to bring State and local government plans into conformity with the general rules, and to provide temporary relief from such rules in the case of certain plans.

Combined plan limitation

An additional limitation applies if an employee participates in a defined benefit pension plan and a defined contribution plan maintained by the same employer. This combined plan limitation prevents avoidance of the separate plan limits through the creation of different types of plans. The limit permits an employee to obtain benefits greater than the single-plan limitation, but precludes an individual from obtaining the maximum possible benefits from both a defined contribution plan and a defined benefit pension plan of the same employer.

Under the combined limit, the sum of the defined benefit plan fraction and the defined contribution plan fraction cannot exceed 1.0. Although the sum of these 2 fractions may not exceed 1.0, the plan fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied with respect to the dollar limits) or 1.4 (as applied to the percentage limits).

The numerator of the defined benefit plan fraction is the projected annual benefit for the participant under the plan determined at the close of the year. The denominator is the lesser of (1) 1.25 multiplied by the dollar limit in effect for the year or (2) 1.4 multiplied by the amount of the 100 percent of compensation limit for the participant for the year.

The numerator of the defined contribution plan fraction is the total amount of annual additions to the participant's account through the close of the year for which the fraction is being determined. The denominator is the sum of the lesser of the following amounts, computed separately for such year and each prior year of service with the employer: (1) 1.25 multiplied by the dollar amount for such year or (2) 1.4, multiplied by the amount of the 25 percent of compensation limit for the participant.

5. Special rules for top-heavy plans

In general

Additional qualification requirements are provided for plans that primarily benefit an employer's key employees (top-heavy plans) (sec. 416). These additional requirements (1) require more rapid vesting, (2) require a minimum nonintegrated benefit for plan participants who are non-key employees, and (3) reduce the overall limit on contributions and benefits for certain key employees.

Except as permitted in Treasury regulations, a plan (whether or not top-heavy in fact) will constitute a qualified plan only if the plan includes provisions that will automatically take effect if the

plan becomes a top-heavy plan and that meet the additional qualification requirements for top-heavy plans.

Definition of top-heavy plan

A defined benefit pension plan is a top-heavy plan for a plan year if (1) the present value of the accumulated accrued benefits for participants who are key employees for the plan year exceeds 60 percent of the present value of the accumulated accrued benefits for all employees under the plan, or (2) the plan is part of a top-heavy group. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, (1) the sum of the account balances of participants who are key employees for the plan year exceeds 60 percent of the sum of the account balances of all employees under the plan, or (2) the plan is a part of a top-heavy group.

Top-heavy groups

Any plan that covers a key employee, and any plan upon which a plan covering a key employee depends for qualification under the coverage or nondiscrimination rules (secs. 401(a)(4) and 410(b)) must be aggregated for purposes of determining whether the plans are top heavy. 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, if such expanded aggregation group continues to satisfy the coverage and nondiscrimination rules.

An aggregation group is a top-heavy group if the sum of (1) the present values of the accumulated accrued benefits for key employees under any defined benefit pension plans included in the group, and (2) the sum of the account balances of key employees under any defined contribution plans included in the group exceeds 60 percent of the same amount determined for all participants under all plans included in the group. If an aggregation group is a top-heavy group, each plan required to be included in the group is a top-heavy plan. No plan included in the aggregation group at the election of the employer is subject to the top-heavy plan rules on account of such election.

Key employees

Key employees generally include employees who (during the plan year or any of the 4 preceding plan years): (1) are officers with compensation greater than 150 percent of the dollar limit for defined benefit pension plans (for 1990, 150 percent of such limit is $153,873), (2) are one of the 10 employees owning the largest interests in the employer and having compensation in excess of the limitation on annual additions to a defined contribution plan (i.e., $30,000), (3) own more than a 5-percent interest in the employer, or (4) own more than a 1-percent interest in the employer and have annual compensation from the employer in excess of $150,000. No more than 50 employees or, if lesser, the greater of 3 employees or 10 percent of all employees need be taken into account as officers.

Additional qualification rules relating to top-heavy plans

Vesting

For any plan year for which a plan is a top-heavy plan, an employee's right to the accrued benefit derived from employer contributions must become nonforfeitable under a vesting schedule that satisfies 1 of 2 alternative schedules. These vesting schedules apply to all accrued benefits, whether or not the accrued benefits are required by the top-heavy plan rules.

A plan will satisfy the first alternative vesting schedule if an employee who has at least 3 years of service with the employer maintaining the plan has a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions. A plan will satisfy the second alternative vesting schedule if an employee 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 with the employer, and 100 percent at the end of 6 years of service with the employer.

Minimum nonintegrated benefit under a defined benefit pension plan for non-key employees

In addition, a qualified plan that is a top-heavy plan must provide a minimum benefit or contribution for each non-key employee who is a participant in the plan. For a plan year for which a defined benefit pension plan is a top-heavy plan, each plan participant who is not a key employee for the year generally must accrue a benefit that, when expressed as an annual retirement benefit, is not less than 2 percent of the employee's average annual compensation 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 generally are required to be taken into account under the minimum benefit rules, except a year of service (1) ending before the date of enactment of the top-heavy rules, or (2) within which ends a plan year for which the plan is not a top-heavy plan. The required minimum benefit cannot be reduced on account of social security benefits (i.e., the minimum benefit is a nonintegrated benefit).

Minimum nonintegrated contribution under a defined contribution plan for non-key employees

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 an amount not less than 3 percent of the participant's compensation. However, if the employer's contribution rate for each participant who is a key employee for the plan year is less than 3 percent, the required minimum contribution rate for each non-key employee generally is limited to not more than the highest contribution rate for any key employee.

The required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to taxes paid by the employer under social security (i.e., the minimum contribution is a "nonintegrated" contribution). If a non-key employee participates in both a defined benefit plan and a defined contribution plan maintained by an employer, the employer is not required by this section to provide the non-key employee with both the minimum benefit and the minimum contribution.

Aggregate limit on contributions and benefits for key employees

The aggregate limit on benefits and contributions (sec. 415(e)) for a key employee who participates in both a defined benefit pension plan and a defined contribution plan that are included in a top-heavy group are reduced, unless (1) 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) is provided for non-key employees participating in the plans, and (2) the plan is not super top-heavy. The extra contribution or benefit is in addition to the minimum contribution or benefit required for all top-heavy plans.

The aggregate limits on contributions and benefits is reduced in all cases for super top-heavy plans. A plan is super top-heavy if it would be determined to be top-heavy if "90 percent" were substituted for "60 percent" in the definition of a top-heavy plan.

6. Definitions

a. Highly compensated employee

In general

For purposes of the qualification rules, an employee, including a self-employed individual, is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5-percent owner of the employer (as defined under the top-heavy rules); (2) received more than $85,485 in annual compensation from the employer; (3) received more than $65,990 in annual compensation from the employer and was a member of the top-paid group of the employer during the same year; or (4) was an officer of the employer (as generally defined under the top-heavy rules) (sec. 414(q)). The $85,485 and $65,990 thresholds are applicable for 1990; these dollar amounts are adjusted annually for inflation at the same time and in the same manner as the adjustments to the dollar limit on benefits under a defined benefit pension plan (sec. 415(d)).[10] The identity of highly compensated employees is to be determined on an employer-wide basis, not on the basis of, for example, a line of business or operating unit.

Officers

An officer will not be treated as a highly compensated employee unless such officer receives compensation greater than 150 percent

[10] These dollar limits were initially set at $75,000 and $50,000, respectively by the Tax Reform Act of 1986.

of the defined contribution plan dollar limit in effect for the year ($30,000 for 1990). No more than 50 employees (or if lesser, the greater of 3 employees or 10 percent of the employees) are to be treated as officers. If, for any year, no officer has compensation in excess of 150 percent of the defined contribution plan dollar limit, then the highest paid officer of the employer for such year is treated as a highly compensated employee. As under the rules applicable for determining top-heavy status (sec. 416), a partnership is considered to have officers.

Top-paid group

The top-paid group of employees includes all employees who are in the top 20 percent of the employer's workforce on the basis of compensation paid during the year. For purposes of determining the size of the top-paid group (but not for identifying the particular employees in the top-paid group), the following employees may be excluded: (1) employees who have not completed 6 months of service; (2) employees who normally work less than 17-1/2 hours per week; (3) employees who normally work not more than 6 months during any year; (4) except to the extent provided in regulations, employees who are included in a unit of employees covered by a collective bargaining agreement; (5) employees who have not attained age 21; and (6) employees who are nonresident aliens and who receive no U.S. source earned income.

For purposes of this special rule, an employer may elect to apply numbers (1), (2), (3), and (5) above by substituting any shorter period of service or lower age than is specified in (1), (2), (3), or (5), as long as the employer applies the test uniformly for purposes of determining its top-paid group with respect to all its qualified plans and employee benefit plans and for purposes of the line of business or operating unit rules described below.

The determination of the top-paid group is made solely with respect to individuals who perform services as an employee at any time during the year. Thus, individuals who separated from service in a prior year are not taken into account in determining the top 20 percent of employees by compensation.

Special rule for determining highly compensated employees for current year

An employee will not be treated as in the top-paid group, as an officer, or as receiving more than $85,485 or $65,990 solely because of the employee's status during the current year, unless such employee also is among the 100 employees who have received the highest compensation during such year. Under this rule, an individual who was a highly compensated employee for the preceding year (without regard to the 1-year lookback or to the application of this special rule) remains highly compensated for the current year.

Thus, the 100-employee rule is intended as a rule of convenience to employers with respect to new employees hired during the current year, with respect to increases in compensation, and with respect to certain other similar factors. If any employee is not a 5-percent owner or within the top-100 employees by compensation for the current year (and was not a highly compensated employee in the preceding year (without regard to this special rule)), then that

employee is not treated as highly compensated for the year, but will be treated as highly compensated for the following year if the employee otherwise falls within the definition of highly compensated employee.

Election to use simplified method

Employers are permitted to elect to determine their highly compensated employees under a simplified method. Under this method, an electing employer may treat employees who received more than $65,990 in annual compensation from the employer as highly compensated employees in lieu of applying the $85,485 thresholds and without regard to whether such employees are in the top-paid 20 percent. This election is available only if at all times during the year the employer maintained business activities and employees in at least 2 geographically separate areas.

Treatment of family members

A special rule applies with respect to the treatment of family members of certain highly compensated employees. Under the special rule, if an employee is a family member of either a 5-percent owner or 1 of the top 10 highly compensated employees by compensation, then any compensation paid to such family member and any contribution or benefit under the plan on behalf of such family member is aggregated with the compensation paid and contributions or benefits on behalf of the 5-percent owner or the highly compensated employee in the top 10 employees by compensation. Therefore, such family member and employee are treated as a single highly compensated employee.

An individual is considered a family member if, with respect to an employee, the individual is a spouse, lineal ascendant or descendant, or spouse of a lineal ascendant or descendant of the employee.

Former employees

A former employee is treated as highly compensated if the employee was highly compensated when (1) such employee separated from service or (2) at any time after the employee attained age 55.

Scope of highly compensated employee definition

The definition of highly compensated employee generally applies for all purposes under the qualified plan rules, but also applies under other Code provisions. Thus, for example, the same definition applies under nondiscrimination rules applicable to tuition reduction programs (sec. 117) and miscellaneous fringe benefits (sec. 132).

b. Compensation

The definition of compensation varies with the purpose for which the definition is used. The Tax Reform Act of 1986 attempted to provide a uniform definition of compensation (sec. 414(s)). This definition in turn is based on the definition of compensation for purposes of the limits on contribution and benefits.

For purposes of the limits on contributions and benefits, compensation generally includes all compensation includible in gross

income. Thus, it includes amounts received for personal services actually rendered in the course of employment, amounts received under an accident or health plan (to the extent that such amounts are includible in gross income), nondeductible moving expenses paid or reimbursed by the employer, and the value of certain nonqualified stock options (to the extent includible in gross income). Compensation for this purpose also includes earned income from sources outside the United States whether or not excludable or deductible from gross income. Compensation does not include contributions to qualified plans and distributions from such plans (even if includible in gross income), amounts realized from the exercise of nonqualified stock options, amounts realized from the sale of stock acquired under a qualified stock option, or other amounts that receive special tax benefits, such as premiums for group-term life insurance (to the extent not includible in gross income).

Compensation that is not currently taxable or that receives special tax treatment is generally excluded for purposes of calculating the limits on benefits and contributions because including such amounts would provide additional tax benefits to amounts that already receive tax-favored treatment.

Under the "uniform" definition of compensation, compensation generally has the same definition as compensation for purposes of the limits on contributions and benefits. However, under this definition, an employer may elect to include elective deferrals by the employee. In addition, the Secretary of the Treasury is authorized to provide for alternative methods of defining compensation, provided such definitions do not discriminate in favor of highly compensated employees. The "uniform" definition is used for purposes of applying the nondiscrimination rules.

In determining who is a highly compensated employee, compensation is defined as under the limits on contributions and benefits, except that compensation includes elective deferrals made by an employee. Elective deferrals are treated as compensation for this purpose because they reflect amounts that could have been paid in cash to the employee and are therefore part of the employee's economic income.

For deduction purposes (sec. 404), compensation generally includes compensation paid or accrued during the year, except for compensation for which a deduction was allowed under the rules relating to employee benefit plans.

c. Employer

In general

For purposes of plan qualification requirements, all employees of certain entities must be aggregated and treated as though employed by a single employer. Under these rules, all employees are considered employed by the same entity to the extent they are employed by corporations that are members of a controlled group (sec. 414(b)), trades or businesses under common control (e.g., related partnerships) (sec. 414(c)), or members of an affiliated service group (sec. 414(m)). In addition, individuals are treated as employees to the extent they are leased employees (sec. 414(n)). The Secretary of the Treasury is authorized to prescribe by regulations such addi-

tional aggregation rules as are necessary to prevent the avoidance of the qualification rules through the use of separate organizations, employee leasing, or other arrangements (sec. 414(o)).

Controlled group of corporations

Employees of related corporations must be considered together for purposes of plan qualification requirements. A controlled group of corporations for this purpose generally is defined as under section 1563(a).

In general, a controlled group of corporations may be either a parent-subsidiary group or a brother-sister group of corporations. A parent-subsidiary group includes one or more chains of corporations connected through stock ownership with a common parent by reason of (a) 80 percent of the voting power or 80 percent of the value of the shares of all classes of outstanding stock (excluding the parent), being owned by one or more of the other corporations, and (b) the parent corporation owning 80 percent of the voting power or 80 percent of the value of the shares of all classes of outstanding stock (excluding stock held by subsidiaries) of at least one of the other corporations.

A brother-sister controlled group is a group of corporations in which 5 or fewer persons who are individuals, estates, or trusts own stock possessing (1) at least 80 percent of the voting power or 80 percent of the total value of all outstanding shares of each corporation; and (2) more than 50 percent of the voting power of all classes of voting stock or more than 50 percent of the value of all shares of each corporation, taking into account the stock ownership of each person only to the extent the ownership is identical with respect to each corporation.

If a corporation is a member of more than one controlled group of corporations, the corporation is treated as a member of each group.

Trades or businesses under common control

Employees must be considered employed by one entity to the extent they are employed by trades or businesses under common control. Like controlled groups of corporations, trades or businesses will be considered under common control if they are classified as a parent-subsidiary or brother-sister group of organizations. The term organization includes for this purpose a sole proprietorship, a partnership, a trust, an estate, or a corporation.

Trades or businesses will be considered under common control if they form a parent-subsidiary group of trades or businesses. This definition is met with respect to the group of organizations connected through ownership of a controlling interest with a common parent if (1) a controlling interest in each of the organizations (except the parent) is owned by one or more of the other organizations; and (2) the common parent owns a controlling interest in at least one other organization. In determining whether the second requirement is met, ownership of the controlled organization held by organizations other than the parent is disregarded.

For purposes of determining whether an organization holds a controlling interest in another organization, the following rules apply. If the controlled organization is a corporation, ownership of

80 percent of the voting power or value of the corporation constitutes a controlling interest. If the controlled organization is a trust or estate, a controlling interest constitutes ownership of 80 percent of the actuarial interest of the trust or estate. If the controlled organization is a partnership, a controlling interest constitutes ownership of 80 percent of the profits interest or capital interest. In the case of a sole proprietorship, ownership of the sole proprietorship is required in order to hold a controlling interest.

A group of trades or businesses will constitute a brother-sister group if (1) the same 5 or fewer persons who are individuals, estates or trusts own a controlling interest in each corporation; and (2) these persons are in effective control of each organization. In determining whether the second requirement is met, effective control constitutes more than 50-percent ownership of an organization. With respect to a sole proprietorship, effective control exists if one of the persons owns the sole proprietorship.

Affiliated service groups

An affiliated service group (sec. 401(m)) consists of a service organization (called the first service organization or FSO) and (1) any service organization which is a shareholder or partner in the FSO and that regularly performs services for the FSO or is regularly associated with the FSO in providing services to the general public, or (2) any other organization if a significant portion of that organization's business (e.g., greater than 5 percent of gross receipts) is performing services for the FSO or for organizations described in (1) above, of a type historically performed in the recipient's service held by employees. In addition, 10 percent or more of the interests in that organization must be held by highly compensated employees of the FSO or another member of the affiliated service group.

If an organization's principal business is performing, on a regular and continuing basis, management functions for another organization, the person performing the functions and the recipient for whom the functions are performed are treated as a single employer.

An organization includes a corporation, partnership, or any other organization. A service organization is an organization where capital is not a material income producing factor. A service organization means an organization the principal purpose of which is the performance of services.

Leased employees

An individual (a leased employee) who performs services for another person (the recipient) may be 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. The individual is to be treated as the recipient's employee only if the individual has performed services for the recipient on a substantially full-time basis (i.e., at least 1500 hours) 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 purposes of determining whether a plan 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 for the recipient are determined by taking into account the entire period for which the leased employee performed services for the recipient. Contributions or benefits for the leased employee which are provided by the leasing organization under a qualified plan are treated as if provided by the recipient to the extent such contributions or benefits are attributable to services performed by the leased employee for the recipient.

An individual who otherwise would be treated as a recipient's employee will not be treated as such an employee if the individual participates in a safe harbor plan maintained by the leasing organization. A plan is a safe harbor plan if it is a money purchase pension plan and if it provides that (1) an individual is a plan participant on the first day on which the individual becomes an employee of an employer maintaining the plan, (2) each employee's rights to or derived from employer contributions under the plan are nonforfeitable at the time the contributions are made, and (3) amounts are to be contributed by the employer on behalf of an employee at a rate not less than 10 percent of the employee's compensation for the year (the 10 percent contribution is not to be reduced by integration with social security).

To be a safe-harbor plan, a plan is required to cover all employees of the leasing organization (beginning with the date they become employees of the leasing organization) other than (1) employees whom the leasing organization demonstrates to the satisfaction of the Secretary performed substantially all of their services for the leasing organization (and not for recipients), and (2) employees whose total compensation from the leasing organization is less than $1,000 during the plan year and during each of the 3 prior plan years.

An employee covered under a safe-harbor plan is to receive the required allocation regardless of the number of hours of service credited to the employee for the year, regardless of whether the employee is employed by the leasing organization on any specified date during the year, and regardless of the employee's age.

Each leased employee is to be treated as an employee of the recipient, regardless of the existence of a safe-harbor plan, if more than 20 percent of an employer's nonhighly compensated workforce are leased employees.

Under Treasury regulations, a special recordkeeping requirement is provided in the case of an employer that has no top-heavy plans (sec. 416), and that uses the services of nonemployees only for an insignificant percentage of the employer's total workforce (i.e., 5 percent).

d. Lines of business or operating unit rules

In general

If an employer is treated as operating separate lines of business or operating units for a year, the employer may apply the nondiscrimination rules separately to each separate line of business or operating unit for that year (sec. 414(r)). This rule does not apply,

however, to any plan that does not satisfy the classification test on an employer-wide basis.

Definitions of line of business and operating unit

The Secretary is to prescribe by regulation what constitutes a separate line of business or operating unit. In general, a line of business or operating unit includes all employees necessary for the preparation of property for sale to customers or for the provision of services to customers. Thus, a headquarters or home office is not to be treated as a separate line of business or operating unit.

In addition, whether claimed lines of business or operating units are separate and bona fide is a facts and circumstances determination requiring examination of each particular situation. Differences and similarities between the services provided and products produced by such claimed lines of business or operating units are important considerations. Also, the manner in which the employer organizes itself is relevant. Thus, if an employer fails to treat itself as comprised of separate lines of business or operating units and treats employees from different claimed lines or units in an equivalent fashion for certain purposes, it may not be appropriate to allow such activities to be treated as separate lines of business or operating units.

Notwithstanding the general rules described above, the line of business or operating unit concept is not to be used to undermine the nondiscrimination rules. Thus, for example, certain job classifications (such as hourly employees or leased employees) are not considered to be separate lines of business or operating units. Also, for example, secretaries and other support service personnel are not a line of business or operating unit separate from the lawyers, other professionals, or other employees for whom such personnel perform services, and nurses and laboratory personnel are not to be treated as in a line of business or operating unit separate from the medical doctors for whom they perform services. In addition, the members of an affiliated service group (sec. 414(m)) may not be treated as separate lines of business or operating units.

Also, an operating unit will not be recognized for purposes of these rules unless, for a bona fide business reason, it is separately operated in a geographic area significantly separate from another operating unit in the same line of business.

Separate maintenance

A line of business or operating unit will generally be recognized as separate if it is separately maintained for bona fide business reasons under the rules described above. However, notwithstanding those rules, a line of business or operating unit will not be treated as separate unless it also satisfies the following 3 requirements:

(1) such line of business or operating unit has at least 50 employees;

(2) the employer notifies the Secretary that such line of business or operating unit is being treated as separate; and

(3) the line of business or operating unit satisfies guidelines prescribed by the Secretary or the employer obtains a determination from the Secretary that the line of business or operating unit may be treated as separate.

Safe harbor

A safe-harbor rule exists under which a separate line of business or operating unit is treated as meeting the third requirement listed above. A line of business or operating unit satisfies this safe-harbor rule if the "highly compensated employee percentage" of the line of business or operating unit is (1) not less than one-half ("50-percent rule"), and (2) not more than twice ("200-percent rule") the percentage of all employees of the employer who are highly compensated. For purposes of this requirement, the 50-percent rule will be deemed satisfied if at least 10 percent of all highly compensated employees of the employer are employed by the line of business or operating unit. The term "highly compensated employee percentage" means the percentage of all employees performing services for a line of business or operating unit who are highly compensated employees.

Excludable employees

For purposes of determining (1) the number of employees in a line of business or operating unit; (2) the highly compensated employee percentage of a line of business or operating unit; and (3) the percentage of all employees of the employer who are highly compensated, an employer is to disregard the categories of employees that are disregarded for purposes of determining which employees are highly compensated employees.

Allocation of employees

Headquarters and other employees are to be allocated to 1 line of business or operating unit under rules prescribed by the Secretary. Generally, this allocation is to be made in accordance with their performance of services.

If an employer is using the separate line of business or operating unit rule with respect to any plan, all employees must be allocated to a line of business or operating unit. Thus, it would not be permissible to maintain that an employer has, in addition to 1 line of business with 50 employees, 10 other employees who are not part of any line of business or operating unit and who would be tested separately.

Attribution of benefits

Benefits attributable to service for a line of business or operating unit are to be considered as provided by that line of business or operating unit. For purposes of these rules, an employee who performs services for more than one line of business or operating unit, but is allocated to one line of business or operating unit under the rules described above, is to be considered to perform services solely for that line of business or operating unit.

Plan years before issuance of guidance

In the case of any plan year beginning on or before the date the Secretary of the Treasury issues guidelines and begins issuing determination letters under the line of business rules, an employer is treated as operating separate lines of business or operating units if

the employer reasonably determines that it meets the requirements of the line of business rules.

C. Treatment of Distributions

1. Uniform minimum distribution rules

Minimum distribution requirements

Present law provides uniform minimum distribution rules generally applicable to all types of tax-favored retirement vehicles, including qualified plans and individual retirement arrangements (IRAs). A uniform rule was adopted because it reduces disparities in opportunities for tax deferral among individuals covered by different types of plans and eases administrative burdens. The minimum distribution rules are designed to ensure that plans are used to fulfill the purpose that justifies their tax-favored status—replacement of a participant's preretirement income at retirement—rather than for the indefinite deferral of tax on a participant's accumulation under the plan.

Under present law, a qualified plan is required to provide that the entire interest of each participant will be distributed no later than the participant's required beginning date (sec. 401(a)(9)). Alternatively, the requirements of present law may be satisfied if the participant's entire interest is distributed in substantially nonincreasing annual payments, beginning no later than the participant's required beginning date, over (1) the life of the participant, (2) the lives of the participant and a designated beneficiary, (3) a period (which may be a term certain) not extending beyond the life expectancy of the participant, or (4) a period (which may be a term certain) not extending beyond the life expectancies of the participant and a designated beneficiary.

The required beginning date for qualified plans is generally the April 1 of the calendar year following the calendar year in which the participant or owner attains age 70-½. In the case of a governmental plan or a church plan, the required beginning date is the later of (1) such April 1, or (2) the April 1 of the year following the year in which the participant retires.

Additional rules apply in the event an employee dies before his or her entire interest in the plan is distributed. In such a case, the minimum distribution requirements depend on whether distributions have begun before the employee's death. If distributions have begun before the employee's death, then the remaining portion of the employee's interest in the plan is required to be distributed at least as rapidly as under the method distributions were being made as of the date of death.

If distributions have not begun before the employee's death, then the employee's interest is required to be distributed within 5 years after the death of the employee. As an alternative to the 5-year rule, the minimum distribution requirements are satisfied in the case of distributions beginning after the employee's death if (1) any portion of the employee's interest is payable to the employee's designated beneficiary, (2) such portion will be distributed over the life of such beneficiary or over a period not extending beyond the life expectancy of the beneficiary, and (3) the distributions begin no

later than one year after the date of the employee's death, or such later date as prescribed in regulations.

If the designated beneficiary is the employee's surviving spouse then distributions under this alternative rule may be further delayed. In particular, in such a case, distributions do not have to begin before the date the employee would have attained age 70-½. If the surviving spouse dies before the distribution to the spouse begins, the alterative rule is applied as if the surviving spouse were the employee. In certain circumstances, payments to the children of a deceased employee may be treated as if they had been made to the surviving spouse.

For purposes of these rules, the life expectancies of the employee and the employee's spouse (other than in the case of a life annuity) may be redetermined not more frequently than annually. The effect of recalculating life expectancies is generally to lengthen the permissible payout period.

Distributions from qualified plans are also required to satisfy an incidental benefits rule. The incidental benefits rule requires that death and other nonretirement benefits (e.g., life, accident, or health benefits) payable under a qualified plan be incidental to the primary purpose of the plan, which is to provide retirement benefits. Under this rule, the relationship of an employee's total benefits under the plan to the retirement benefits or deferred compensation payable to the employee must be such that the primary purpose of the plan is to provide retirement benefits. The incidental benefits rule may in some cases require distributions in addition to those required under the minimum distribution rules. The distributions required under this rule are described in revenue rulings and Treasury regulations.

Excise tax on failure to make a minimum required distribution

Under present law, the sanction for failure to make a minimum required distribution to a participant (or other payee) under a qualified retirement plan is a 50-percent nondeductible excise tax on the excess in any taxable year of the amount required to have been distributed under the minimum distribution rules, including the incidental benefits rule (the "minimum required distribution") over the amount that actually was distributed (sec. 4974). The tax is imposed on the individual required to take the distribution. However, a plan will not satisfy the applicable qualification requirements unless it expressly provides that, in all events, distributions under the plan are to satisfy the minimum distribution requirements.

The Secretary of the Treasury is authorized to waive the tax for a given taxable year if the taxpayer to whom the tax would otherwise apply establishes that any shortfall between the minimum required distribution for that year and the amount actually distributed during the year is due to reasonable error, and that reasonable steps are being taken to remedy the shortfall.

The sanction for failure to satisfy the minimum distribution rules is an excise tax rather than plan disqualification because Congress believed that the sanction of disqualification was too onerous for a plan's failure in operation to satisfy technical distribution requirements with respect to any one participant. Disqualifica-

tion might result in adverse tax consequences to all plan participants or all highly compensated plan participants, even though the plan administrator was responsible for the failure to make a required distribution, and the failure may have occurred with respect to only a single participant. Although Congress believed that a plan should, by its terms, prohibit the violation of the minimum distribution rules, Congress also believed an operational error should not cause plan disqualification.

2. Withdrawal rules

Present law limits the circumstances under which plan participants may obtain distributions from a qualified plan. In general, these restrictions recognize that qualified plans are intended to provide retirement income.

The least restrictive rules apply to profit-sharing and stock bonus plans. Amounts may generally be withdrawn from such plans after they have been in the plan for 2 years. Distributions before the expiration of such 2-year period may also be made in the event of retirement, death, disability, other separation from service, or hardship.

Distributions from qualified pension plans (i.e., defined benefit pension plans and money purchase pension plans) may generally be made only in the event of retirement, death, disability or other separation from service. The same restrictions generally apply to plans that are integrated with social security.

Special rules apply to qualified cash or deferred arrangements (sec. 401(k)). Elective deferrals under a qualified cash or deferred arrangement (and earnings thereon) may only be distributed on account of separation from service, death, or disability, or attainment of age 59-½. Elective deferrals (but not earnings thereon) may also be distributed on account of a hardship of the employee.

3. Cashout and survivor benefit rules

Present law contains a number of rules designed to preserve qualified plan benefits for retirement and to provide for income to the surviving spouse of a deceased employee.

Under present law, if the present value of the vested benefit of a plan participant exceeds $3,500, then that benefit may not be distributed prior to retirement age without the consent of the employee (sec. 411(a)(11)). This rule provides plan participants who separate from service before retirement age with the option of leaving their plan benefits in the plan until they retire.

Under the spousal protection rules, present law requires defined benefit pension plans and money purchase pension plans to provide that retirement benefits are payable in the form of a qualified joint and survivor annuity or, in the case of a participant who dies before the annuity starting date, a qualified preretirement survivor annuity.

The survivor benefit rules do not apply to other types of defined contribution plans if (1) the plan provides that, upon the death of the particpant, the participant's accrued benefit is payable to the participant's surviving spouse, (2) the participant does not elect payment of benefits in the form of an annuity, and (3) the plan is

not a transferee plan of a plan subject to the joint and survivor rules.

Benefits may be paid in a form other than a joint and survivor annuity or a preretirement survivor annuity with the consent of the particpant's spouse. Similarly, under a defined contribution plan, the spouse can consent to have benefits paid to another beneficiary. The Code provides detailed rules regarding the consent requirements.

4. Taxation of distributions [11]

In general

Under present law, a distribution of benefits from a tax-favored retirement arrangement generally is includible in gross income in the year it is paid or distributed under the rules relating to taxation of annuities, unless the amount distributed represents the employee's investment in the contract (i.e., basis) (secs. 72 and 402). Special rules apply in the case of lump sum distributions from a qualified plan, distributions that are rolled over to an IRA, and distributions of employer securities.

Early distributions from qualified plans and other tax-favored retirement vehicles are subject to an additional 10-percent income tax (sec. 72(t)). Excess distributions from qualified plans and other tax-favored retirement vehicles are subject to a 15-percent tax.

Basis recovery rules

In general

A participant in a qualified plan may have basis in the plan, e.g., because the participant has made after-tax contributions to the plan. In such cases, present law provides rules for determining what portion of each distribution is taxable and what portion is a nontaxable return of employee contributions. These rules depend in part on whether the distribution is an annuity or nonannuity distribution and when the distribution is made.

In all cases, under the basis recovery rules, the total amount that an employee may exclude from income cannot exceed the total amount of the employee's basis. In addition, if benefits cease prior to the date the basis has been fully recovered, the amount of unrecovered basis is allowed as a deduction for the last taxable year distributions are received by the annuitant. If an employee dies and benefit payments continue to be made to the employee's beneficiary, the beneficiary recovers the remaining basis with respect to the employee under the general rules.

Annuity distributions

In the case of amounts received as an annuity on or after the annuity starting date, each payment received by an employee generally is treated, in part, as a return of the employee's basis and, in

[11] The rules relating to the taxation of pension distributions were substantially revised in the Tax Reform Act of 1986. The 1986 Act contains a number of detailed transition rules which preserve the pre-1986 Act tax treatment in certain circumstances. For a detailed description of these rules, see Joint Committee on Taxation, *General Explanation of the Tax Reform Act of 1986* (JCS-10-87), May 4, 1987.

part, as taxable income. The portion of each payment treated as a return of the employee's basis is that amount which bears the same ratio to each payment as the employee's total basis bears to the total expected payments over the period of the annuity. For example, if an employee's contributions to a plan are 10 percent of the total expected payments, then 10 percent of each annuity distribution is a nontaxable return of basis, and 90 percent is includible in income.

If the expected return depends in whole or in part on an individual's life expectancy (e.g., a life annuity) the expected return is computed in accordance with actuarial tables prescribed by the Secretary of the Treasury. The IRS has issued a safe harbor method for calculating the tax-free portion of an annuity by authorizing the use of a simplified method of determining the expected number of payments (IRS Notice 88-118).

Nonannuity distributions

In the case of distributions not received in the form of an annuity and that are paid before the annuity starting date, basis is generally recovered on a pro-rata basis. That is, a distribution is generally treated as a return of basis in the proportion that the employee's basis bears to the account balance.

With respect to distributions that are not received in the form of an annuity and that are paid on or after the annuity starting date, the amount received is deemed to be attributable first to income on the contract and is therefore includible in income.

The annuity starting date is the first day of the first period for which an amount is received as an annuity.

Separate accounting for employee contributions

Under present law, employee contributions to a defined contribution plan or a separate account of a defined benefit pension plan may be treated as a separate contract for purposes of the basis recovery rules. Thus, if an employee withdraws amounts from such a separate contract either before or after the employee's annuity starting date, then for tax purposes, the distribution will be considered to be part nontaxable, i.e., a return of employee contributions, and part taxable, i.e., a distribution of earnings on those contributions. The distribution will not, however, be considered to be attributable to employer contributions. If an employee withdraws all amounts attributable to employee contributions and such amount is less than the total employee contributions, the employee may recognize a loss.

A plan may designate the contract from which a distribution is made either expressly through a plan provision or in practice by crediting a particular contract when a distribution is made under the plan. Alternatively, a participant can be permitted to designate the contract from which a distribution is made.

Rollovers

Under present law, a total or partial distribution of the balance to the credit of an employee under a qualified plan, a qualified annuity plan, or a tax-sheltered annuity may, under certain conditions, be rolled over, tax free, to an IRA or another qualified plan

or annuity. A rollover of a partial distribution is permitted if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects treatment. A partial distribution may only be rolled over to an IRA and not to another qualified plan.

The maximum amount of a distribution that can be rolled over is the amount of the distribution that is taxable. That is, employee contributions cannot be rolled over. The rollover must be made within 60 days after the distribution was received.

Lump-sum distributions

Under present-law, lump-sum distributions are eligible for special 5-year forward income averaging. In general, a lump-sum distribution is a distribution within one taxable year of the balance to the credit of an employee which becomes payable to the recipient (1) on account of the death of the employee, (2) after the employee attains age 59-½, (3) on account of the employee's separation from service, or (4) in the case of self-employed individuals, on account of disability. In addition, a distribution to an employee is treated as a lump sum distribution only if the employee has been a participant in the plan for at least 5 years before the year of the distribution.

A taxpayer is permitted to make an election with respect to a lump-sum distribution received on or after the employee attains age 59-½ to use 5-year forward income averaging under the tax rates in effect for the taxable year in which the distribution is made. However, only one such election on or after age 59-½ may be made with respect to any employee.

Net unrealized appreciation

Under present law, a taxpayer is not required to include in gross income amounts received in the form of a lump-sum distribution to the extent that the amounts are attributable to net unrealized appreciation in employer securities. Such unrealized appreciation is includible in gross income when the securities are sold or exchanged.

The special treatment of net unrealized appreciation applies only if a valid lump-sum distribution election is made, but disregarding the 5-plan years of participation requirement for lump-sum distributions.

Additional income tax on early distributions

Under present law, an additional income tax is imposed on certain early distributions from any "qualified retirement plan" (sec. 72(t)). The tax applies to amounts distributed from qualified plans, tax-sheltered annuities and custodial accounts, and IRAs. The rate of the tax is 10 percent for all early distributions includible in gross income. A plan is not required to withhold the amount of the additional income tax on an early withdrawal.

The purpose of the early distribution tax is to prevent diversion of retirement savings for nonretirement purposes. The tax is designed to discourage preretirement withdrawals and to recapture a measure of the tax benefits that have been provided under the plan.

The additional income tax on early distributions does not apply to the following distributions: (1) a distribution made after the employee (or owner) attains age 59-½, (2) a distribution that is part of a scheduled series of substantially equal periodic payments for the life or life expectancy of the participant (or the joint lives or life expectancies of the participant and the participant's beneficiary); (3) a distribution to an employee who has attained age 55 and subsequently separated from service; (4) a distribution made to an employee to the extent such distribution does not exceed the amount of deductible health expenses for the year (sec. 213) (determined without regard to whether the taxpayer itemizes deductions); and (5) distributions after the death of the employee (or owner).

In addition, the early withdrawal tax does not apply to the following distributions: (1) payments made to or on behalf of an alternate payee pursuant to a qualified domestic relations order (sec. 414(p)); (2) certain distributions of excess contributions, excess deferrals, or excess aggregate contributions; and (3) dividend distributions for which the employer is allowed a deduction (section 404(k)).

The 10-percent additional tax applies only to amounts includible in gross income. Thus, it does not apply to amounts representing the return of after-tax employee contributions or amounts rolled over into an IRA or another qualified plan.

In the case of distributions from IRAs (including simplified employee pensions (SEPs)), the age 55 and medical expense exceptions do not apply. The exception for distributions pursuant to a qualified domestic relations order applies to an IRA only to the extent the IRA is subject to the rules relating to qualified domestic relations orders. The exception for substantially equal payments applies to distributions from plans qualified under section 401(a) or 403(a) and tax-sheltered annuities and custodial accounts only if the distribution is made after separation from service.

Tax on excess distributions

In general

Present law imposes a 15-percent excise tax on excess distributions with respect to an individual during any calendar year from qualified retirement plans, tax-sheltered annuities, and IRAs (sec. 4980A). The purpose of the tax is to limit the total amount that can be accumulated on behalf of a particular individual on a tax-favored basis. In enacting the excise tax, Congress believed that an individual should not be permitted to accumulate excessive retirement savings, regardless of whether such excess was attributable to the receipt of multiple maximum benefits from several employers, very large appreciation in defined contribution plans, or the use of IRAs by individuals receiving significant employer-provided benefits.

Distributions subject to the tax

In determining whether the distributions received by an individual are subject to the tax, aggregate annual distributions made with respect to an individual from all pension, profit-sharing, stock bonus, and annuity plans, IRAs, and tax-sheltered annuities generally are taken into account.

Certain amounts, however, are excluded in determining such aggregate annual distributions. Excludable distributions include (1) amounts representing a return of an individual's after-tax contributions (but not earnings thereon) or other amounts that are treated as part of the individual's investment in the contract; (2) amounts excluded from the recipient's income because they are rolled over to another plan or an IRA; and (3) amounts excluded from the participant's income because they are payable to a former spouse pursuant to a qualified domestic relations order (sec. 414(p)) and includible in the spouse's income.

Distributions made with respect to a participant after the death of the participant are disregarded in applying this annual limit and are subject instead to an additional estate tax, described below.

Definition of excess distributions

Excess distributions are defined as the aggregate amount of retirement distributions made with respect to any individual during any calendar year, to the extent such amounts exceed the greater of (1) $150,000 or (2) $128,228 for 1990. The dollar limit in (2) is indexed annually for inflation.

A special higher ceiling applies for purposes of calculating the excess distribution for any calendar year in which an individual receives a lump-sum distribution that is taxed under the 5-year income averaging rules.[12] The higher ceiling is 5 times the otherwise applicable ceiling for such calendar year.

If an individual receives other retirement distributions during a taxable year in addition to a lump-sum distribution eligible for the special higher ceiling, the other retirement distributions are separately subject to the general rules relating to excess distributions and, thus, are subject to the 15-percent excise tax only to the extent that the aggregate of such other retirement distributions during the taxable year exceeds the generally applicable annual limit.

Post-death distributions

Present law provides special rules to calculate the extent to which retirement distributions made with respect to an individual after the individual's death are excess distributions. In lieu of subjecting post-death distributions (including distributions of death benefits) to the annual tax on excess distributions, present law imposes an additional estate tax equal to 15 percent of the individual's excess retirement accumulation. After the estate tax is imposed, post-death distributions are disregarded entirely in applying this tax. Thus, beneficiaries who are receiving distributions with respect to an individual after the individual's death (other than certain former spouses receiving benefits pursuant to a qualified domestic relations order) are not required to aggregate those amounts with any other retirement distributions received on their own behalf.

The excess retirement accumulation is defined as the excess (if any) of the value of the decedent's interests in all qualified retire-

[12] The special rule is also available if the individual elects capital gains treatment or 10-year averaging under the grandfather rules included in the Tax Reform Act of 1986.

ment plans, annuity plans, tax-sheltered annuities, and IRAs, over the present value of annual payments equal to the annual ceiling ($150,000 or the applicable dollar limit in effect on the date of death), over a period equal to the life expectancy of the individual immediately before death.

In calculating the amount of the excess retirement accumulation, the value of the decedent's interest in all qualified plans, tax-sheltered annuities, and IRAs will be taken into account regardless of the number of beneficiaries. However, the amount of excess retirement accumulations does not include the value of any death benefits payable immediately after death with respect to a decedent to the extent that the sum of such death benefits plus other benefits payable with respect to the decedent exceeds the total value of benefits payable with respect to the decedent immediately prior to death. Also, benefits that represent the decedent's investment in the contract or amounts payable to an alternate payee and includible in the alternate payee's income are also disregarded in determining the excess retirement accumulation.

5. Treatment of loans

In general

Under present law, an individual is permitted to borrow from a qualified plan in which the individual participates (and to use a portion of his or her accrued benefit as security for the loan) provided the loan is made in accordance with specific provisions contained in the plan, bears a reasonable rate of interest, is adequately secured, provides a reasonable repayment schedule, and is not made available on a basis that discriminates in favor of highly compensated employees (sec. 4975).[13]

A loan to a plan participant is treated as a taxable distribution of plan benefits unless the loan meets certain requirements relating to the amount of the loan and the repayment period for the loan (sec. 72(p)). Present law also includes limits on the deductibility of interest on participant loans in addition to the general rules restricting the deductibility of personal interest.

The rules governing the tax treatment of loans from certain tax-favored plans are intended to limit the extent to which an employee may currently use assets held by a plan for nonretirement purposes and to ensure that loans are actually repaid within a reasonable period. The loan restrictions also reflect Congressional belief that the favorable tax treatment of amounts set aside in qualified plans should be targeted at providing employees with retirement income security, and that any exceptions to this general policy should be narrowly limited.

Amount of loan

In order not to be treated as a distribution under present law, a loan, when added to the outstanding balance of all other loans from all plans of the employer, cannot exceed the lesser of (1)

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[13] A self-employed individual may not borrow from a qualified plan unless an administrative exemption from the prohibited transaction rules is granted by the Secretary of Labor. The prohibited transaction rules are discussed below.

$50,000 reduced by the excess of the highest outstanding balance of loans from such plans during the 1-year period ending on the day before the date the loan is made over the outstanding balance of loans from the plan on the date the loan is made, or (2) the greater of (a) $10,000 or (b) one-half of the participant's vested accrued benefit under the plan.

For example, under the $50,000 rule, assume a participant with a vested benefit of $200,000 borrows $30,000 from a plan on January 1. On November 1, the participant wants to borrow an additional amount without triggering a taxable distribution. At that time, the outstanding balance on the first loan is $20,000. The maximum amount that the participant can borrow is $20,000, i.e., $50,000 - [$20,000 + ($30,000 - $20,000)].

Repayment period

Under present law, a loan is treated as a taxable distribution unless the loan is required, by its terms, to be repaid within 5 years, unless the loan is used to purchase or improve the principal residence of the participant.

Present law requires that plan loan repayments (principal and interest) be amortized in level payments, made not less frequently than quarterly, over the term of the loan. This requirement does not preclude repayment or acceleration of the loan prior to the end of the commitment period or the use of a variable interest rate.

Deductibility of interest

Present law provides for the disallowance of the deduction for interest paid by (1) all employees on loans secured by elective deferrals (or the income attributable thereto) under a qualified cash or deferred arrangement or tax-sheltered annuity or custodial account, and (2) key employees with respect to loans from any qualified plan or tax-sheltered annuity or custodial account. These restrictions are in addition to the otherwise applicable restrictions on the deductibility of personal interest. No basis is created in a participant's account with respect to any nondeductible interest paid on a loan from a qualified plan or tax-sheltered annuity or custodial account.

D. Funding and Deduction Rules

1. Minimum funding requirements

In general

Under the Code, certain pension plans, including money purchase pension plans, are required to meet a minimum funding standard for each plan year (sec. 412). The present-law funding rules do not apply to (1) profit-sharing or stock bonus plans, (2) certain plans funded by insurance contracts, (3) governmental plans, (4) church plans, (5) plans that have not provided for employer contributions after September 2, 1974, and (6) certain plans maintained by a fraternal beneficiary societies (sec. 501(c)(8) or voluntary employees' beneficiary associations (sec. 501(c)(9)).

In the case of a money purchase pension plan, the contribution required by the minimum funding standard is generally the contri-

bution rate specified by the plan. Defined benefit pension plans are funded on an actuarial basis, and the minimum funding rules for such plans are more complex. A discussion of those rules follows.

As an administrative aid in the application of the funding standard, each defined benefit pension plan is required to maintain a special account called a "funding standard account" to which specified charges and credits (including credits for contributions to the plan) are to be made for each plan year. If, as of the close of a plan year, the account reflects credits equal to or in excess of charges, the plan is treated as meeting the minimum funding standard for the year. Thus, as a general rule, the minimum contribution for a plan year is determined as the amount by which the charges to the account would exceed credits to the account if no contribution were made to the plan.

Calculation of contribution

Actuarial cost methods

In general.—A defined benefit pension plan is required to use an acceptable actuarial cost method to determine the balance in its funding standard account for a year. Generally, an actuarial cost method divides the cost of benefits under the plan into annual charges consisting of 2 elements for each plan year. These elements are referred to as (1) normal cost, and (2) past service liability.

Normal cost.—The normal cost of a plan for a year generally represents the cost of future benefits allocated to the year by the funding method used by the plan for current employees and, under some funding methods, for separated employees. The normal cost will be funded by future contributions to the plan (1) in level dollar amounts, (2) as a uniform percentage of payroll, (3) as a uniform amount per unit of service (e.g., $1 per hour), or (4) on the basis of the actuarial present values of benefits accruing under the plan in particular plan years.

Past service liability.—The past service liability element represents the cost of future benefits under the plan that will not be funded by future plan contributions to meet normal cost (1) on the date the plan is first effective, or (2) the date a plan amendment increasing plan benefits is first effective. Under some funding methods, there is no past service liability component.

Acceptable methods.—Normal cost and past service liability are key elements in computations under the minimum funding standard. Although these costs may differ substantially, depending upon the actuarial cost method used to value a plan's assets and liabilities, they must be determined under an actuarial cost method permitted by the Code. The Code enumerates 6 acceptable actuarial cost methods and provides that additional methods may be permitted under Treasury regulations. Normal costs and past service liabilities under a plan are computed on the basis of an actuarial valuation of the assets and liabilities of a plan. Generally, an actuarial valuation is required at least once every plan year.

Charges and credits to the funding standard account

In general.—Under the minimum funding standard, the portion of the cost of a plan that is required to be paid for a particular

year depends upon the nature of the cost. For example, the normal cost for a year is generally required to be funded currently. On the other hand, costs with respect to past service (for example, the cost of retroactive benefit increases), experience losses, and changes in actuarial assumptions, are spread over a period of years.

Normal cost.—Each plan year, a plan's funding standard account is charged with the normal cost assigned to that year under the particular acceptable actuarial cost method adopted by the plan. The charge for normal cost will require an offsetting credit in the funding standard account. Usually, an employer contribution is required to create the credit.

For example, if the normal cost for a plan year is $150,000, the funding standard account would be charged with that amount for the year. Assuming that there are no other credits in the account to offset the charge for normal cost, an employer contribution of $150,000 will be required for the year to avoid an accumulated funding deficiency.

Past service liability.—There are 3 separate charges to the funding standard account that may arise as the result of past service liabilities. The first applies to a plan under which past service liability has increased due to a plan amendment made after January 1, 1974; the second applies only to a plan that came into existence after January 1, 1974; and the third applies only to a plan in existence on January 1, 1974. Past service liabilities result in annual charges to the funding standard account for a specified period of years.

Gains and losses from changes in assumptions.—If the actuarial assumptions used for funding a plan are revised and, under the new assumptions, the accrued liability of a plan is less than the accrued liability computed under the previous assumptions, the decrease is a gain from changes in actuarial assumptions. If the new assumptions result in an increase in the accrued liability, the plan has a loss from changes in actuarial assumptions. The accrued liability of a plan is the actuarial present value of projected pension benefits under the plan that will not be funded by future contributions to meet normal cost. Under the funding standard, the gain or loss for a year from changes in actuarial assumptions is amortized over a period of 10 plan years (30 plan years in the case of a multiemployer plan).

Experience gains and losses.—In determining plan funding under an actuarial cost method, a plan's actuary generally makes certain assumptions regarding the future experience of a plan. These assumptions typically involve rates of interest, mortality, disability, salary increases, and other factors affecting the value of assets and liabilities. If, on the basis of these assumptions, the contributions made to the plan result in actual unfunded liabilities that are less than anticipated by the actuary, then the excess is an experience gain. If the actual unfunded liabilities are greater than those anticipated, then the difference is an experience loss. For a single-employer plan, experience gains and losses for a year are amortized over a 5-year period (15 plan years in the case of a multiemployer plan).

Waived funding deficiencies.—Under the funding standard, the amount of a waived funding deficiency is amortized over a period

of 5 plan years, beginning with the year in which the waiver is granted. Each year the funding standard account is charged with the amount amortized for that year unless the plan becomes fully funded. The interest rate used for purposes of determining the amortization on the waived amount is the greater of (1) the rate used in computing costs under the plan, or (2) 150 percent of the mid-term applicable Federal interest rate (AFR) in effect for the first month of the plan year.

Switchback liability.—The Code provides that certain plans may elect to use an alternative minimum funding standard account for any year in lieu of the funding standard account. The Code prescribes specified annual charges and credits to the alternative account. No accumulated funding deficiency is considered to exist for the year if a contribution meeting the requirements of the alternative account is made, even if a smaller contribution is required to balance charges and credits in the alternative account than would be required to balance the funding standard account for a plan year.

During years for which contributions are made under the alternative account, an employer must also maintain a record of the charges and credits to the funding standard account. If the plan later switches back from the alternative account to the funding standard account, the excess, if any, of charges over credits at the time of the change ("the switchback liability") must be amortized over a period of 5 plan years.

Reasonableness of actuarial assumptions.—All costs, liabilities, interest rates, and other factors are required to be determined on the basis of actuarial assumptions and methods (1) each of which is reasonable individually or (2) which result, in the aggregate, in a total plan contribution equivalent to a contribution that would be obtained if each assumption were reasonable. In addition, the assumptions are required to reflect the actuary's best estimate of experience under the plan.

Special rules for underfunded plans

In general

A special funding rule applies to underfunded single-employer defined benefit pension plans (other than plans with no more than 100 participants on any day in the preceding plan year). This special funding rule was adopted due to Congressional concerns regarding the solvency of the defined benefit pension plan system and that the generally applicable funding rules were not in all cases sufficient to ensure that plans would be adequately funded.

Calculation of deficit reduction contribution

With respect to plans subject to the special rule, the minimum required contribution is, in general, the greater of (1) the amount determined under the normal funding rules, or (2) the sum of (i) normal cost, (ii) the amount necessary to amortize experience gains and losses over 5 years and gains and losses resulting from changes in actuarial assumptions over 10 years, and (iii) the deficit reduction contribution. In addition, a special funding rule applies with respect to benefits that are contingent on unpredictable events. In

no event is the amount of the contribution to exceed the amount necessary to increase the funded ratio of the plan to 100 percent.

The deficit reduction contribution is the sum of (1) the unfunded old liability amount, and (2) the unfunded new liability amount. Calculation of these amounts is based on the plan's current liability.

Current liability

The term "current liability" generally means all liabilities to employees and their beneficiaries under the plan (sec. 401(a)(2)) determined as if the plan terminated. However, the value of any "unpredictable contingent event benefit" is not taken into account in determining current liability until the event on which the benefit is contingent occurs.

The interest rate used in determining the current liability of a plan, as well as the contribution required under the special rule, is required to be within a specified range. The permissible range is defined as a rate of interest that is not more than 10 percent above or below the average mid-term applicable Federal rate (AFR) for the 4-year period ending on the last day before the beginning of the plan year for which the interest rate is being used (or, if shorter, the period that the AFR has been computed). The Secretary may, where appropriate, allow a lower rate of interest except that such rate may not be less than 80 percent of the average rate discussed above.

Within the permissible range, the interest rate is required to be reasonable. The determination of whether an interest rate is reasonable depends on the cost of purchasing an annuity sufficient to satisfy current liability. The interest rate is to be a reasonable estimate of the interest rate used to determine the cost of such annuity, assuming that the cost only reflected the present value of the payments under the annuity (i.e., and did not reflect the seller's profit, administrative expenses, etc.).

Unfunded current liability means, with respect to any plan year, the excess of (1) the current liability under the plan over (2) the value of the plan's assets reduced by any credit balance in the funding standard account. The funded current liability percentage of a plan for a plan year is the percentage that (1) the value of the plan's assets reduced by any credit balance in the funding standard account is of (2) the current liability under the plan.

Unfunded old liability amount

The unfunded old liability amount is, in general, the amount necessary to amortize the unfunded old liability under the plan in equal annual installments (until fully amortized) over a fixed period of 18 plan years (beginning with the first plan year beginning after December 31, 1988). The "unfunded old liability" with respect to a plan is the unfunded current liability of the plan as of the beginning of the first plan year beginning after December 31, 1987, determined without regard to any plan amendment adopted after October 16, 1987, that increases plan liabilities (other than amendments adopted pursuant to certain collective bargaining agreements).

Unfunded new liability amount

The unfunded new liability amount for a plan year is the applicable percentage of the plan's "unfunded new liability." Unfunded new liability means the unfunded current liability of the plan for the plan year, determined without regard to (1) the unamortized portion of the unfunded old liability (and the unamortized portion of certain unfunded liability from certain benefit increases) and (2) the liability with respect to any unpredictable contingent event benefits, without regard to whether or not the event has occurred. Thus, in calculating the unfunded new liability, all unpredictable contingent event benefits are disregarded, even if the event on which that benefit is contingent has occurred.

If the funded current liability percentage is less than 35 percent, then the applicable percentage is 30 percent. The applicable percentage decreases by .25 of one percentage point for each 1 percentage point by which the plan's funded current liability percentage exceeds 35 percent.

Unpredictable contingent event benefits

The value of any unpredictable contingent event benefit is not considered in determining current liability until the event has occurred. If the event on which an unpredictable contingent event benefit is contingent occurs during the plan year and the assets of the plan are less than current liability (calculated after the event has occurred), then an additional funding contribution (over and above the minimum funding contribution otherwise due) is required.

Unpredictable contingent event benefits include benefits that depend on contingencies that, like facility shutdowns or reductions or contractions in workforce, are not reliably and reasonably predictable. The event on which an unpredictable contingent event benefit is contingent is generally not considered to have occurred until all events on which the benefit is contingent have occurred.

The amount of the additional contribution is generally equal to the greater of (1) the unfunded portion of the benefits paid during the plan year (regardless of the form in which paid), including (except as provided by the Secretary) any payment for the purchase of an annuity contract with respect to a participant with respect to unpredictable contingent event benefits, and (2) the amount that would be determined for the year if the unpredictable contingent event benefit liabilities were amortized in equal annual installments over 7 years, beginning with the plan year in which the event occurs.

The rule relating to unpredictable contingent event benefits is phased in for plan years beginning in 1989 through 2001.

Small plan rule

In the case of a plan with more than 100 but no more than 150 participants during the preceding year, the amount of the additional deficit reduction contribution is determined by multiplying the otherwise required additional contribution by 2 percent for each participant in excess of 100.

Full funding limitation

No contribution is required or permitted under the minimum funding rules to the extent the plan is at the full funding limitation. In addition, under present law, subject to certain limitations, an employer may make deductible contributions to a defined benefit pension plan up to the full funding limitation. The full funding limitation is generally defined as the excess, if any, of (1) the lesser of (a) the accrued liability under the plan (including normal cost) or (b) 150 percent of the plan's current liability, over (2) the lesser of (a) the fair market value of the plan's assets, or (b) the actuarial value of the plan's assets (sec. 412(c)(7)).

The Secretary may, under regulations, adjust the 150-percent figure contained in the full funding limitation to take into account the average age (and length of service, if appropriate) of the participants in the plan (weighted by the value of their benefits under the plan). In addition, the Secretary is authorized to prescribe regulations that apply, in lieu of the 150 percent of current liability limitation, a different full funding limitation based on factors other than current liability. The Secretary may exercise this authority only in a manner so that in the aggregate, the effect on Federal budget receipts is substantially identical to the effect of the 150-percent full funding limitation.

Time for making contributions

Under present law, the required contribution for a plan year must be made within 8-½ months after the end of the plan year. If the contribution is made by such due date, the contribution is treated as if it were made on the last day of the plan year. In the case of single-employer defined benefit pension plans, 4 installments of estimated contributions are required during the plan year with the total contribution due within 8-1/2 months after the end of the plan year (sec. 412(m)). The amount of each required installment is one-fourth of the lesser of (1) 90 percent of the amount required to be contributed for the current plan year or (2) 100 percent of the amount required to be contributed for the preceding plan year. The requirement for quarterly contributions is phased-in so that it is fully effective for plan years beginning in 1992 and thereafter.

In the event that an employer fails to make a required installment, interest is charged to the funding standard account. The interest rate on missed contributions is the greater of (1) 175 percent of the mid-term applicable Federal interest rate (AFR) or (2) the rate of interest taken into account in determining costs under the plan. Interest continues at the specified rate until the missed contributions are actually paid to the plan.

In the case of a plan with a funded ratio of less than 100 percent, a statutory tax lien arises on all controlled group property in favor of the plan 60 days after the due date of an unpaid contribution (whether or not a waiver application is pending). This lien only arises when the unpaid balance due to the plan exceeds $1,000,000. The amount of the lien generally is the cumulative missed contributions in excess of $1 million.

Funding waivers

Within limits, the IRS is permitted to waive all or a portion of the contributions required under the minimum funding standard for a plan year. A waiver may be granted if the employer (or employers) responsible for the contribution could not make the required contribution without temporary substantial business hardship. A waiver may be granted only if the business hardship is temporary and if the entire controlled group of which the employer is a member, as well as the employer itself, is experiencing the hardship. No more than 3 waivers may be granted within any period of 15 consecutive plan years. The IRS may require an employer to provide security as a condition of granting a waiver.

The IRS is authorized to require security to be granted as a condition of granting a waiver of the minimum funding standard if the sum of the plan's accumulated funding deficiency and the balance of any outstanding waived funding deficiencies exceeds $1 million.

Controlled group liability

The funding requirements applicable to a plan are imposed on all employers that are members of the same controlled group of corporations as the employer who is responsible for making the contributions.

Sanction for failure to meet minimum funding standard

If, as of the close of any plan year, charges to the funding standard account exceed credits to the account, then the excess is referred to as an "accumulated funding deficiency." Unless a minimum funding waiver is obtained, an employer who is responsible for contributing to a plan (and the controlled group of which the employer is a part) with an accumulated funding deficiency is subject to a 10-percent nondeductible excise tax (5 percent in the case of a multiemployer plan) on the amount of the deficiency (sec. 4971). If the deficiency is not corrected within the "taxable period," then an employer who is responsible for contributing to the plan (and the controlled group of which the employer is a part) is also subject to a nondeductible excise tax equal to 100 percent of the deficiency. The taxable period is the period beginning with the end of the plan year in which there is a deficiency and ending on the earlier of (1) the date of a mailing of a notice of deficiency with respect to the 10-percent tax, or (2) the date on which the 10-percent tax is assessed by the IRS.

2. Deduction rules

In general

The contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits (sec. 404). No deduction is allowed, however, for a contribution that is not an ordinary and necessary business expense or an expense for the production of income. The deduction limits applicable to an employer's contribution depend on the type of plan to which the contribution is made and may depend on whether an employee covered by the plan is also covered by another plan of the employer. However, no deduction is allowed with respect to contributions or

benefits in excess of the overall limits on contributions or benefits (sec. 404(j)).

Profit-sharing and stock bonus plans [14]

In the case of a qualified profit-sharing or stock bonus plan, employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid (sec. 404(a)(3)). If employer contributions for a group of employees for a particular year exceed the deduction limits, then the excess may be carried over and deducted in later years (within limits).

Defined benefit pension plans

As discussed above, employer contributions under a defined benefit pension plan are required to meet a minimum funding standard (sec. 412). The deduction allowed for an employer's contribution to a defined benefit pension plan is limited to the greatest of the following amounts:

(1) the amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year;

(2) the level amount (or percentage of compensation) necessary to provide for the remaining unfunded cost of the past and current service credits of all employees under the plan (adjusted, if applicable, by a 10-year amortization of experience gains or losses) over the remaining future service of each employee. Under the Code, however, if the remaining unfunded cost with respect to any 3 individuals is more than 50 percent of the cost for all employees, then the cost attributable to each of those employees is spread over at least 5 taxable years;

(3) an amount equal to the normal cost of the plan plus, if past service or certain other credits are provided, an amount necessary to amortize those credits plus experience gains or losses in equal annual payments over 10 years (sec. 404(a)(1)).

In determining the amount deductible under these rules, the funding method and actuarial assumptions and by the plan for purposes of the minimum funding rules are used. No deduction is allowed for contributions in excess of the full funding limitation.

A special deduction rule applies to underfunded defined benefit pension plans. In the case of a single-employer defined benefit pension plan which has more than 100 participants, the maximum amount deductible is not less than the plan's unfunded current liability as determined under the minimum funding rules.

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible to the extent required by the minimum funding standard. Under a qualified money purchase pension plan, the amount required under the minimum funding standard is the contribution rate specified by the plan.

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[14] Special deduction rules apply in the case of leveraged ESOPs.

Combination of pension and other plans

If an employer maintains a defined benefit pension plan and a defined contribution plan for the same employee for the same year, then the employer's deduction for contributions for that year is generally limited to the greater of (1) 25 percent of the aggregate compensation of employees covered by the plans for the year, or (2) the contribution necessary to meet the minimum funding requirements of the defined benefit pension plan for the year.

Compensation taken into account

Under present law, for 1990 no more than $209,200 of any employee's compensation for a year may be taken into account in computing deductions for plan contributions. The limit is adjusted annually for cost-of-living increases at the time and in the manner provided for the adjustment of the overall limits on annual benefits under a qualified defined benefit pension plan. Increases in the compensation limit may not be taken into account before they occur in determining the deduction limit for plan contributions.

Excise tax on nondeductible contributions to qualified plans

Under present law, a 10-percent nondeductible excise tax is imposed on nondeductible contributions to a qualified plan. The purpose of the excise tax is to discourage employers from making excessive contributions to a plan in order to obtain the benefit of tax-free growth on the contributions.

The contributions to a plan that are subject to the excise tax on nondeductible contributions are (1) the amounts contributed to a qualified employer plan by the employer for the taxable year in excess of the amount allowable as a deduction for the taxable year, plus (2) the unapplied amounts in the preceding taxable year. The unapplied amounts in the preceding taxable year are the amounts subject to the excise tax in the preceding year reduced by the sum of (1) the portion of the amounts that are returned to the employer during the taxable year, and (2) the portion of such unapplied amounts that are deductible during the current taxable year.

For example, assume that an employer made a nondeductible contribution of $100,000 for its 1988 taxable year. Assume further that, for its 1989 taxable year, the employer's contribution was $75,000 and the deductible limit was $150,000. Assume that no amount is returned to the employer and that the employer's contribution for 1990 is equal to the deductible limit for that year. Under present law, the excise tax would apply to the nondeductible contributions of $100,000 for the 1988 taxable year and to the nondeductible contributions of $25,000 for the 1989 and 1990 taxable years.

E. Terminations and Reversions

In general

Present law defines the rights of plan participants and beneficiaries, as well as employers, in the event of a termination of a qualified plan. The rules relating to plan terminations depend in part on whether the plan is a defined contribution plan or a defined benefit pension plan. One of the main differences in the rules

arises from the fact that it is possible under a defined benefit plan to accumulate excess assets. In the case of a defined contribution plan, plan contributions generally are required to be allocated to accounts of plan participants so that there is no accumulation of excess assets. As described above, defined benefit pension plans are funded on an actuarial basis, so that it is possible that assets in excess of those required to provide for plan benefits exist at the time of the plan termination.

Permanency requirement

An employer may reserve the right to change or terminate a qualified plan or to discontinue benefits thereunder. However, in order to be a qualified plan, the plan is required to be a permanent program rather than a temporary program. The termination of the plan for any reason other than business necessity within a few years after it has taken effect is evidence that the plan was not a bona fide program for the exclusive benefit of employees in general. Whether or not a plan that has terminated meets the permanency requirement depends on all the facts and circumstances. For example, in the case of a profit-sharing plan, it is not necessary that the employer contribute every year or that it contribute the same amount every year. On the other hand, a circumstance which may involve a violation of the permanency rule is termination of a defined benefit pension plan soon after pensions have been fully funded for highly compensated employees.

Payment of benefits upon early termination

The Code and regulations contain specific rules designed to prevent discrimination in favor of highly compensated employees upon early termination of a qualified plan. A qualified pension plan is required to include provisions that restrict the use of employer contributions to fund the benefit of the 25 top-paid employees of the employer in the event of early termination of the plan (Treas. reg. sec. 1.401-4(c)). The restrictions apply to employees who are among the 25 top-paid employees at the time the plan is established and whose anticipated annual pension under the plan exceeds $1,500. The events that trigger the restrictions are termination of the plan within 10 years after its establishment or the benefits of such an employee becoming payable within 10 years after the establishment of the plan.

The restrictions do not generally affect the payment of retirement benefits to such an employee while the plan is in operation. However, a lump sum distribution may be paid to such an employee during the period the restriction is in effect only if the employee agrees to repay the actuarial value of the restricted portion of the benefits upon early termination and such agreement is adequately secured.

Vesting

A plan is not a qualified plan unless the plan provides that the interests of plan participants in the plan become fully vested upon plan termination. For this purpose, a plan termination includes a full or partial termination of the plan, or, in the case of a profit-sharing, stock bonus, or other plan not subject to the minimum

funding requirements, the complete discontinuance of contributions under the plan.

A defined benefit pension plan is generally considered terminated when it is voluntarily terminated by the employer or involuntarily terminated by the PBGC. A defined contribution plan is considered terminated when it is voluntarily terminated by the employer. Whether a complete discontinuance of contributions (as compared to a temporary suspension of contributions) has occurred is determined based on all the facts and circumstances. Factors relevant in determining whether a complete discontinuance has occurred include whether the employer is calling an actual discontinuance of contributions a suspension in order to avoid full vesting or for any other reason, whether employer contributions are recurring and substantial, and whether there is any reasonable probability that the lack of contributions will continue indefinitely.

Whether a partial termination has occurred is also determined on a facts and circumstances basis. Factors relevant to this determination include the exclusion, by reason of plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan and plan amendments which adversely affect the rights of employees to vest in benefits under the plan. If a defined benefit pension plan ceases or decreases future benefit accruals under the plan, a partial termination is deemed to occur if, as a result of such cessation or decrease, a potential reversion to the employer is created or increased.

Special rules for defined benefit pension plans; employer reversions

Under the Code, a trust forming part of a pension plan is not qualified unless under the trust instrument it is impossible, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries under the trust, for any part of the trust assets to be used for, or diverted to, purposes other than for the exclusive benefit of employees or their beneficiaries (sec. 401(a)(2)). However, upon termination of the defined benefit pension plan and after satisfaction of all fixed and contingent liabilities of the participants and beneficiaries (termination liability), the employer may recover any excess assets remaining in the trust that are due to erroneous actuarial computations (Treas. reg. sec. 1.401-2(b)(1)).[15]

Similarly, under ERISA [16] the assets of an employee benefit plan may not inure to the benefit of any employer and are to be held for the exclusive purposes of providing benefits to participants in the plan and their beneficiaries and defraying reasonable expenses of administering the plan. However, as under the Code, any excess assets of a plan may be distributed to the employer upon termination of the plan if (1) all liabilities of the plan to participants and

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[15] A reversion is also possible in limited circumstances in the case of a defined contribution plan. Under present law, a suspense account may be maintained to hold amounts that cannot currently be allocated to plan participants because of the limitations on benefits and contributions (sec. 415). In certain cases, amounts remaining in the suspense account on termination of the plan may revert to the employer.

[16] Both ERISA and the Code also permit the return of contributions to the employer in certain limited situations prior to the termination of the plan, for example, contributions made by mistake of fact, contributions conditioned on the initial qualification of the plan, and contributions conditioned on the deductibility of the contribution. ERISA sec. 403(c)(2), Code sec. 401(a)(2), Rev. Rul. 77-200, 1977-1 C.B. 98.

their beneficiaries have been satisfied, (2) the distribution does not contravene any provision of law, and (3) the plan provides for such a distribution.

Under present law, upon the termination of the plan all accrued benefits must become 100 percent vested and nonforfeitable. In addition, the accrued benefits must be distributed or annuitized, that is, annuities providing for the payment of accrued benefits must be purchased and distributed to participants.

Under present law, whether the employer has the right to the excess assets or must share excess assets with plan participants is generally determined under the plan document. Thus, if the plan document provides that the employer is entitled to the reversion of excess assets, the employer is not required to share the reversion with participants.[17]

Although an employer technically is not permitted to recover excess assets except upon termination of a plan, present law permits certain transactions that in effect permit the withdrawal of assets from an ongoing plan. Typical examples of such transactions are termination-reestablishment and spinoff-termination transactions.

In a termination-reestablishment transaction, the employer terminates a defined benefit pension plan, recovers the excess assets, and then establishes a "new" plan that covers the same employees and provides the same or substantially similar benefits as the old plan. In a typical spinoff-termination transaction, a single plan is split into two plans, one plan covering retirees and one covering active employees. The excess assets are allocated to the plan covering retirees. That plan is then terminated, allowing the employer to recover the excess assets.[18]

In response to concern that reversions can reduce the security of participants' benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans" or the "Implementation Guidelines," were issued by Treasury, the Department of Labor, and the PBGC as a news release on May 24, 1984.

The Implementation Guidelines set forth administrative procedures for processing certain terminations of qualified defined benefit pension plans involving reversions of excess assets to the plan sponsor. The guidelines generally provide that a bona fide termination of a defined benefit pension plan will be recognized as having occurred under either a spinoff-termination or a termination-reestablishment transaction only if certain conditions are met.

A spinoff-termination is considered bona fide under the guidelines only if (1) the benefits of all employees are vested as of the date of the termination, (2) all benefits accrued by all employees as of the date of the termination are provided for by the purchase of annuity contracts, (3) the continuing plan adopts a special funding

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[17] Under ERISA, except in the case of a new plan, a plan provision providing that excess assets revert to the employer generally is not effective until for 5 years after the provision is adopted.

[18] In some circumstances, present law may restrict the amount of assets that may be allocated to a plan upon a plan spin-off (sec. 414(l)).

method (with the approval of the IRS), and (4) appropriate notice is provided to employees.

Under the Implementation Guidelines, termination-reestablishment transactions are generally recognized as bona fide. If the new plan provides credit for service before that plan was adopted, however, the guidelines do not treat the transaction as bona fide unless a special funding method is adopted (with the approval of the IRS).

The guidelines note that spinoff-terminations or termination-reestablishments may affect the qualified status of plans under the tax law because the Code requires that qualified plans be permanent. The guidelines generally provide that the permanency requirement prohibits an employer that has engaged in a spinoff-termination or termination-reestablishment transaction from engaging in another such transaction for at least 15 years.

Asset reversions are includible in the gross income of the employer receiving the reversion. In addition, employer reversions are subject to an excise tax equal to 15 percent of the reversion (sec. 4980). The excise tax was enacted in order to recapture the tax benefit received by the employer from the tax-free growth of plan contributions.

F. Prohibited Transaction Rules

In order to prevent persons with a close relationship to a plan from using that relationship to the detriment of plan participants and beneficiaries, the Code prohibits certain transactions between a plan and a disqualified person (sec. 4975). A disqualified person includes any fiduciary, a person providing services to the plan, an employer any of whose employees are covered by the plan, an employee organization any of whose members are covered by the plan, and certain persons related to such disqualified persons.

Transactions prohibited include (1) the sale or exchange, or leasing of property between the plan and a disqualified person, (2) the lending of money or other extension of credit between the plan and a disqualified person, (3) the furnishing of goods, services, or facilities between the plan and a disqualified person, or (4) the transfer to, or use by or for the benefit of, a disqualified person, of any assets of the plan.

The Code contains a number of statutory exemptions to the prohibited transaction rules. These rules also permit the Secretary of the Treasury and the Secretary of Labor, respectively, to grant exemptions from the prohibited transaction rules on a case-by-case basis. The prohibited transaction exemption program under both the Code and ERISA generally is administered by the Secretary of Labor.

The Code imposes a two-tier excise tax on prohibited transactions. The initial level tax is equal to 5 percent of the amount involved with respect to the transaction. In any case in which the initial tax is imposed and the prohibited transaction is not corrected within a certain period, a tax equal to 100 percent of the amount involved may be imposed. Each disqualified person engaging in the prohibited transaction (other than a fiduciary acting as such) is jointly and severally liable for the excise taxes. The Secretary of the Treasury has authority to waive the second-level tax.

For purposes of determining the amount of the excise tax, the amount involved means the greater of the amount of money and the fair market value of other property received. For example, if a disqualified person obtains a one-year loan from a plan at an interest rate of 6 percent, and the fair market value of the use of the funds is 10 percent, the amount involved is 10 percent times the amount of the loan.

To correct a prohibited transaction means to undo the transaction to the extent possible. In any event, the plan must be placed in a financial position not worse than that in which it would be in if the disqualified person acted under the highest fiduciary standards.

III. LEGISLATIVE BACKGROUND

In general

Prior to 1921, no special tax treatment applied to employee retirement trusts. Retirement payments to employees and contributions to pension trusts were deductible by the employer as an ordinary and necessary business expense. Employees were taxed on amounts actually received as well as on employer contributions to a trust if there was a reasonable expectation of benefits accruing from the trust.

Since 1921, in order to stimulate the adoption of retirement plans by employers, the Internal Revenue Code has specifically provided that certain employee trusts are exempt from Federal income tax. The 1921 Code provided an exemption for a trust forming part of a qualified profit-sharing or stock bonus plan. The 1926 Code provided a similar exemption for qualified pension trusts and established deduction limits to limit the extent to which tax-favored treatment would be available under qualified plans. A number of changes to the qualification rules and deduction limits were made prior to the enactment of the 1954 code.

The special tax treatment afforded employee trusts was retained in the 1954 Code. Section 401(a) (and sections referred to therein) contains the basic qualification standards which a trust must satisfy in order to be exempt from tax under section 501(a); section 404 limits the amount of contributions that can be deducted; and section 402 and 72 govern the taxation of benefits distributed to employees.

The standards applicable to qualified plans have been revised over time to reflect Congressional concerns related to the expansion of pension, profit-sharing, and stock bonus plans and the prevention of tax abuses. The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 ("ERISA"), which added minimum participation, coverage, vesting, benefit accrual, and funding requirements, and overall limits on contributions and benefits. The next comprehensive revision of the rules was made by the Tax Reform Act of 1986. Further revisions of the rules were made by the Tax Reduction Act of 1975, the Tax Reform Act of 1976, the Revenue Act of 1978, the Economic Recovery Tax Act of 1981, the Tax Equity and Fiscal Responsibility Act of 1982, the Deficit Reduction Act of 1984, the Retirement Equity Act of 1984, the Consolidated Omnibus Budget Reconciliation Act of 1986, the Omnibus Budget Reconciliation Act of 1987 (including the Pension Protection Act), the Technical and Miscellaneous Revenue Act of 1988, and the Revenue Reconciliation Act of 1989 (included in the Omnibus Budget Reconciliation Act of 1989). The major legislative revisions are discussed below.

Employee Retirement Income Security Act of 1974

The Employee Retirement Income Security Act of 1974 ("ERISA"), enacted on September 2, 1974, forms the basis for the modern private pension system. ERISA established a comprehensive legislative program addressing almost all major aspects of employer-provided pensions and reflects Congressional concern that certain minimum standards for private pension plans are necessary to provide adequate retirement security for plan participants.

ERISA's requirements included minimum participation rules which limit the age and service requirements an employer can impose as a condition of participation in the plan; general and numerical coverage and nondiscrimination rules designed to ensure that pension plans benefit a substantial portion of an employer's rank and file employees as well as highly compensated employees; benefit accrual and vesting rules which limit the period of service an employer can impose before an employee earns or is entitled to receive a pension benefit; and minimum funding standards designed to ensure the solvency of defined benefit and money purchase pension plans.

ERISA also contained limitations on the tax benefits for employer-maintained plans. Thus, ERISA provided that contributions to such plans are deductible, within limits, and included limitations on the benefits that can be accumulated by a plan participant and the contributions that can be made on behalf of a plan participant.

ERISA also added prohibited transaction rules which are designed to prevent misuse of plan assets by plan fiduciaries and others closely associated with the plan.[19]

Tax Reduction Act of 1975

The Tax Reduction Act of 1975 provided that employers could qualify for a credit against income tax by making contributions to an ESOP that meets certain requirements. The amount of the credit was based on the employer's qualified investments.

Tax Equity and Fiscal Responsibility Act of 1982

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 ("TEFRA"), different rules applied to retirement plans maintained by incorporated employers and unincorporated employers (such as partnerships). In general, plans maintained by unincorporated employers were subject to special rules in addition to the other qualification requirements of the Code. For example, such plans were subject to lower limits on contributions and benefits than other types of qualified plans. TEFRA eliminated most of this disparity and, for the most part, applied the same rules to all

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[19] ERISA established a dual system regulating private pension plans. In addition to modifying Internal Revenue Code provisions, ERISA added significant labor law provisions regulating employer-sponsored pension plans. The labor law provisions included minimum participation, vesting, accrual, funding, and prohibited transaction rules substantially similar to those of the Code. The labor law provisions also include standards regulating the conduct of plan fiduciaries, rules regarding the rights of plan participants and disclosures of plan provisions to plan participants and a termination insurance program administered by the Pension Benefit Guaranty Corporation. A detailed discussion of the labor law provisions relating to pension plans is beyond the scope of this pamphlet.

types of qualified plans without regard to whether or not the employer was incorporated.

For taxable years beginning after 1983, TEFRA added special qualification requirements for plans which primarily benefit an employer's key employees (referred to as "top-heavy plans"). The additional requirements included faster vesting rules and minimum benefit requirements.

TEFRA added the basic employee leasing rules, under which an individual who performs services for another person is treated as the recipient's employee where the services are performed pursuant to an agreement between the recipient and a leasing organization. These rules were designed to prevent avoidance of the qualification requirements through innovative employment structures that do not represent the true employment relationship. TEFRA also expanded the class of employees who, under the affiliated service group rules, are to be treated as employed by a single employer for purposes of the qualification rules.

TEFRA also reduced the maximu limits on contributions and benefits under qualified plans. In addition, TEFRA repealed the investment-based ESOP tax credit and replaced it with a credit for ESOP contributions based on the compensation of plan participants.

Deficit Reduction Act of 1984

The Deficit Reduction Act of 1984 ("DEFRA") expanded the special tax benefits for ESOPs. In particular, DEFRA provided for deferral of recognition of gain on certain sales of stock to an ESOP, an employer deduction for dividends paid on certain stock held by an ESOP, the exclusion of 50 percent of the interest paid on certain loans to an ESOP, and the assumption of estate tax liability by an ESOP.

DEFRA also made miscellaneous changes to the employee leasing rules, distribution rules, nondiscrimination rules for cash or deferred arrangements, and certain other qualification requirements.

Retirement Equity Act of 1984

The Retirement Equity Act of 1984 ("REA") reflected Congressional concern that the previous qualification rules did not adequately reflect changing work patterns of workers and their spouses and did not provide adequate protection for the surviving spouse of the worker. REA demonstrated Congressional concern that workers, and particularly women, often enter the work force at an earleir age and leave and re-enter the work place at various times during their careers with the result that they often did not earn a pension benefit under prior law.

REA lowered the minimum age employers may require individuals to attain before they participate in a pension plan, and modified the rules relating to the service that must be taken into account for purposes of vesting and benefit accural (including special rules for maternity and paternity leave), spousal survivor benefits, the distribution of qualified plan benefits upon divorce, and the protection of accrued benefits.

Tax Reform Act of 1986

The Tax Reform Act of 1986 (the "1986 Act"), contains the most comprehensive revision to the qualified plan rules since ERISA. The 1986 Act made changes to the limitations on tax deferral under qualified plans, nondiscrimination rules, tax treatment of distributions, and special rules for ESOPs.

With respect to the tax deferral provided to qualified plans, the 1986 Act lowered the maximum limits on benefits and contributions, imposed a cap on elective deferrals under qualified cash or deferred arrangements, and added a tax on aggregate excess distributions from all tax-favored retirement plans of an individual.

The 1986 Act also imposed a tax on nondeductible employer contributions to qualified employer plans, and added a 10-percent excise tax on employer reversions. The tax on reversions was intended to recapture the tax benefits of deferral on income earned on plan contributions.

The 1986 Act made a number of changes to the coverage and nondiscrimination rules. The Act added a uniform definition of highly compensated employee, the minimum participation rule, reduced the permitted disparity between contributions for highly and nonhighly compensated employees under qualified cash or deferred arrangements, and added nondiscrimination rules for employee contributions and employer matching contributions similar to the rules applicable to cash or deferred arrangements.

The 1986 Act also modified the minimum coverage rules, generally reducing the disparity between benefits of highly and nonhighly compensated employees. Prior to the 1986 Act, the rules relating to integration of qualified plans permitted an employer to eliminate all qualified plan benefits for lower-paid employees. The 1986 Act modified the integration rules by generally reducing the amount by which benefits for lower-paid employees could be reduced due to social security and ensuring that all employees covered by the plan receive some benefit under the plan.

The 1986 Act reflects further Congressional concern for workers who change jobs frequently, particularly women and minorities. Thus, the Act provides for more rapid vesting than permissible under prior law.

In the area of plan distributions, the 1986 Act provided for more uniform distribution rules for IRAs, qualified plans, and other tax-favored retirement vehicles. The 1986 Act also provided for a more uniform 10-percent tax on early withdrawals from tax-favored retirement vehicles. This tax had previously applied only to IRAs and certain distributions from top-heavy plans.

The 1986 Act revised the rules relating to income taxation of qualified plans. In general, the 1986 Act modified the basis recovery rules to provide for pro rata basis recovery, provided for 5-year averaging of lump sum distributions (as compared with 10-year averaging under prior law), and eliminated capital gains treatment for qualified plan distributions.

The 1986 Act modified the rules relating to ESOPs by requiring that ESOP stock be valued by an independent appraiser and that an ESOP provide employees close to retirement age the opportunity to diversify plan investments. The 1986 Act also eliminated the

tax credit for contributions to ESOPs, expanded certain other special tax benefits for ESOPs, and added an estate tax deduction for sales for securities by an executor to an ESOP.

Omnibus Budget Reconciliation Act of 1987

The Omnibus Budget Reconciliation Act of 1987 (including the Pension Protection Act) modified the minimum funding requirements applicable to single-employer defined benefit pension plans and the maximum amount that may be deducted for contributions to such plans. These changes were designed to eliminate excessive overfunding and underfunding of defined benefit pension plans.

The Pension Protection Act (PPA) was prompted by Congressional concern over the solvency of the single-employer defined benefit pension plan system. The PPA recognized that the prior-law funding rules were not in all cases sufficient to ensure that defined benefit pension plans are adequately funded in the event of plan termination. Thus, PPA required more rapid funding for underfunded plans, accelerated the time for making plan contributions, and made other changes relating to funding.

In passing the Omnibus Budget Reconciliation Act of 1987, Congress was also concerned that prior law permitted employers desiring to do so to excessively overfund pension plans and obtain tax deductions for liabilities that have not yet been accrued by the plan. Thus, the Act added the 150-percent of current liability full funding limitation.

Revenue Reconciliation Act of 1989

The Revenue Reconciliation Act of 1989 (included in the Omnibus Budget Reconciliation Act of 1989) modified the special tax benefits for ESOPs. The Act restricted the availability of the partial interest exclusion for ESOP loans to cases in which the ESOP owns more than 50 percent of the stock of the employer, modified the tax-free rollover provisions, and repealed the estate tax deduction for sales of stock to an ESOP and other miscellaneous ESOP provisions.

The Act also made numerous technical corrections to the PPA.

IV. ISSUES RELATING TO THE SIMPLIFICATION OF EMPLOYEE PENSION BENEFITS TAX LAWS [20]

Overview

There are three potential sources of income for an individual after retirement—social security benefits, employer-provided pension plan benefits, and personal savings. These three sources of retirement income have traditionally been referred to as the three-legged stool providing retirement income security. Taken together, these three sources of income ideally should provide an adequate replacement for preretirement income.

An employer's decision to establish or continue a pension plan for employees is voluntary. The Federal tax laws provide favorable tax treatment for amounts contributed to an employer-provided pension plan to encourage the establishment and continuance of such plans.

The Federal laws and regulations governing employer-provided retirement benefits are recognized as among the most complex set of rules applicable to any area of the tax law. Some have argued that this complexity has made it difficult, if not impossible, for employers, particularly small employers, to comply with the law. In addition, it is asserted that this complexity deters employers from establishing pension plans or forces the termination of such plans. If this assertion is accurate, then the complexity of the employee benefits laws is reducing the number of employees covered under employer-provided plans. Such a result would then force social security and personal savings to assume more of the burden of replacing preretirement income.

Others assert that the complexity of employee benefits laws and regulations is a necessary byproduct of attempts (1) to ensure that retirement benefits are delivered to more than just the most highly compensated employees of an employer, (2) to provide employers, particularly large employers, with the flexibility needed to recognize the differences in the way that employers do business; and (3) to ensure that retirement benefits generally are used for retirement purposes.

A brief discussion follows of the reasons for complexity in the pension area and of possible issues to be considered in the development of legislative proposals to reduce this complexity.

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[20] This discussion is phrased in terms of pension benefits because the focus of this pamphlet is complexity in pension laws. However, the discussion is also applicable to other types of employee benefits (e.g., health benefits), as well as the tax generally.

Reasons for complexity in employee pension benefits laws

Retirement policy vs. tax policy

A source of complexity in the development of pension laws and regulations occurs because the Federal Government has chosen to encourage the delivery of retirement benefits by employers through the Federal income tax system. This decision tends to create conflicts between retirement income policy and tax policy.

Retirement income policy has as its goal the delivery of adequate retirement benefits to the broadest possible class of workers. Because the decision to maintain a retirement plan for employees is voluntary, retirement income policy would argue for laws and regulations that do not unduly hinder the ability or the willingness of an employer to establish a retirement plan. Such a policy might also encourage the delivery of more retirement benefits to rank-and-file employees by adopting a rule that prohibits discrimination in favor of highly compensated employees, but does not otherwise limit the amount of benefits that can be provided to such employees. Thus, an employer whose principal objective was to provide large retirement benefits to highly compensated employees (e.g., management) could do so as long as the employer also provided benefits to rank-and-file employees.

On the other hand, tax policy will be concerned not only with the amount of retirement benefits being delivered to rank-and-file employees, but also will be concerned with the extent to which the Federal Government is subsidizing the delivery of such benefits. Thus, Federal tax policy requires a balancing of the tax benefits provided to an employer who maintains a qualified plan in relation to all other tax subsidies provided by the Federal tax laws. This balancing has led the Congress (1) to limit the total amount of benefits that may be provided to any one employee by a qualified plan and (2) to adopt strict nondiscrimination rules to prevent highly compensated employees from receiving a disproportionate amount of the tax subsidy provided with respect to qualified pension plans.

Jurisdiction of pension legislation

When ERISA was enacted in 1974, the Congress concluded that Federal pension legislation should be developed in a manner that limited the Federal tax subsidy of employer-provided retirement benefits and that provided adequate safeguards for the rights of employees whose employers maintained pension plans. Accordingly, the rules adopted in ERISA included changes in the tax laws governing qualified plans (Title II of ERISA) and also included labor law requirements applicable to employer-provided plans (Title I of ERISA). In many cases, these labor law requirements mirrored the requirements of the tax laws and created a civil right of action for employees. Thus, ERISA ensured that compliance with the Federal employee benefits laws could be monitored by the Federal government (through the IRS and the Department of Labor) and by employees (through their civil right of action under the labor laws).

Although many of the pension laws enacted in ERISA had mirror provisions in the labor laws and in the Internal Revenue Code, subsequent legislation has not always followed the same

form. For example, the top-heavy rules that were enacted as part of the Tax Equity and Fiscal Responsibility Act of 1982 were only included in the Internal Revenue Code and did not contain a corresponding provision in Title I of ERISA. Some have argued that such a piecemeal approach to employee benefits legislation can lead to inconsistencies between the Federal tax law and Federal labor law and can contribute to the overall complexity of the rules governing pension plans.

In addition, the enforcement of rules relating to employer-provided pension plans is shared by the IRS and the Department of Labor. Thus, there is no single agency of the Federal Government that is charged with the development and implementation of regulations and with the operational enforcement of the rules relating to pension plans.

Although the authority of each applicable agency has been clarified, complexity can occur because of the manner in which the agencies interact. An employer must determine the agency with which it must consult on an issue and may find that the goals of each agency are different. For example, the Pension Benefit Guaranty Corporation (PBGC) views the funding of a defined benefit pension plan from its goal of assuring solvency of the plan when benefit payments are due. On the other hand, the IRS is also concerned that employers should not be permitted to overfund defined benefit pension plans as a mechanism by which the employer can shelter income from taxation. Without careful coordination of the goals of these 2 Federal agencies, employers may receive inconsistent directives.

Volume and frequency of employee benefits legislation

Many employers and practitioners in the pension area have argued that the volume of legislation affecting pension plans enacted since 1974 has contributed to complexity. In many cases, a particular substantive area of pension law may be dealt with legislatively every year. For example, the rules relating to the form and taxation of distributions from qualified pension plans were significantly changed by TEFRA, DEFRA, and the Tax Reform Act of 1986. In many cases, changes in the rules are lobbied for by employers and practitioners.

This constant change of the law has not only contributed to complexity for the employer, plan administrator, or practitioner who must understand the rules, but has also created problems for the IRS and Department of Labor. Regulations projects are so backlogged at the IRS that employers may not know what they must do to bring their pension plans into compliance with enacted legislative changes because the IRS has been unable to publish adequate guidance for employers.

The amount of legislation in the pension area in recent years hinders the ability of the IRS and the Department of Labor to monitor compliance with the law. Significant amounts of resources are required to be expended to educate government employees with respect to changes in the law. Time that is spent reviewing pension plan documents to determine whether they qualify under the tax laws in form takes time away from the auditing of plans to ensure that they qualify in operation.

The level of legislative and regulatory activity in the pension area has also created problems because inadequate time is available to consider the possible interaction of various provisions. The IRS may issue regulations that are immediately superseded by legislation. Legislation is enacted that does not consider the potential interaction problems created with other areas of employee benefits law.

Some people argue that the rules relating to employer-provided pension plans should not be significantly altered in the context of an effort to simplify the rules. This argument assumes that additional changes in the employee benefits area will only contribute to complexity by legislating again in an area that some say has been overlegislated in the last 10 years.

On the other hand, legislative initiatives that merely repeal existing rules may not contribute to additional complexity of the rules unless the repeal of such rules leaves uncertainty as to the rule that applies in place of the repealed rule.

The structure of the workplace

Some argue that the complexity of the rules relating to pensions stems from a problem that is not unique to the employee benefits area—that is, the way in which the workplace has developed has created inherent complexities in the way that legislation is enacted. The way in which employers do business affects the complexity of pension legislation.

Large employers tend to have complex structures. These complex structures may include the division of employees among various subsidiaries that are engaged in different types of businesses. Rules are required to deal with the issues that arise because a business is operated in many tiers. For example, questions arise as to which employees are required to be taken into account in determining whether an employer is providing pension benefits on a nondiscriminatory basis. To what extent are employees of various subsidiaries that are engaged in completely different activities required to be aggregated? If these employees must be aggregated for testing purposes, what kind of recordkeeping burdens are imposed on the employer? How are headquarters employees treated and how does the treatment of such employees differ from the treatment of subsidiary employees? If an employer retains temporary workers, to what extent are such workers required to be taken into account? Should employees covered by collective bargaining agreements be treated differently than other employees? Employers face these issues every day because of the way in which their businesses are operated, rather than simply because the laws governing pension benefits are complex.

Flexibility and complexity

Employers and employees generally want to be able to tailor their compensation arrangements, including pension benefits, to fit their particular goals and circumstances. Present-law accommodates these desires by providing for various tax-favored retirement savings vehicles, including qualified plans, individual retirement arrangements (IRAs), simplified employee pensions (SEPs), and tax-sheltered annuities. There are many different types of qualified

plans, different ways of funding such plans, and different ways of providing benefits under such plans.

The number of different tax-favored retirement vehicles increases complexity in the pension rules because different rules are needed for each type of arrangement. A great deal of simplicity could be achieved, for example, if employers were permitted to choose from only one or two model pension plans. However, this would also greatly reduce the flexibility provided employers and employees under present law.

Certainty created by complexity

Although employers and practitioners often complain about the complexity of the rules relating to employer-provided pension plans, some of that complexity is, in fact, attributable to the desire of employers or the Congress to have certainty in the rules. For example, the general nondiscrimination rule relating to qualified pension plans merely requires that a plan not discriminate in either contributions or benefits in favor of highly compensated employees. This rule is easy to articulate; however, determining whether or not the rule is satisfied is not a simple task. The most obvious problem is determining what the word "discriminate" means. If it means that there can be no difference in contributions or benefits between those provided to highly compensated employees and those provided to rank-and-file employees, then the rule is fairly straightforward. However, because the rules permit employers some flexibility to provide more contributions or benefits for highly compensated employees, then it is necessary to determine how much of a difference in the contributions or benefits is permitted. On the other hand, rules that provide greater certainty for employers tend, on their face, to appear to be more complex. A case in point are the nondiscrimination rules for employee benefits added in the Tax Reform Act of 1986 (sec. 89).[21] Employers complained vigorously about the calculations and recordkeeping requirements imposed by section 89. However, these rules developed during the legislative consideration of the 1986 Act in large measure in response to employer's complaints about the uncertainty of a general rule prohibiting nondiscrimination in favor of highly compensated employees.

A more mechanical rule will often appear to be more complex but will also provide more certainty to the employers, plan administrators, and practitioners who are required to comply with the rule. Thus, any attempts to reduce complexity of the employee benefits laws must balance the desire for simplicity against the perceived need for certainty. In addition, it should be recognized that simplicity in legislation does not preclude complexity in regulation.

Transition rules

When the Congress enacts tax legislation altering the tax treatment of qualified pension plans or distributions from such plans, transition relief is often provided to specific employers or individual taxpayers or to a class of employers or taxpayers. Transition

[21] The rules of section 89 were repealed in 1989 (P.L. 101-140).

relief generally delays temporarily or permanently the application of the enacted rule to the applicable taxpayer. Sometimes, transition relief will apply a modified rule that is a compromise between present law and the enacted rule.

The adoption of transition rules for a taxpayer or a class of taxpayers contributes to the actual and perceived complexity of employee benefits laws.

Possible considerations in developing proposals to reduce complexity of the employee benefits laws

In analyzing a proposal to simplify the rules relating to employer-provided pension plans, the following issues will be relevant: (1) the extent to which the proposed change is consistent with the underlying policy objectives of the rule that is altered; (2) whether a complete revision of rules that employers and plan administrators understand and use should be made solely in the interest of simplification; (3) whether additional legislation with respect to a rule that has already been subject to significant legislation itself creates complexity; (4) the extent to which transition rules and grandfather rules contribute to complexity; and (5) whether any attempt to simplify the rules relating to employer-provided pension plans should be required to be revenue neutral with respect to present law.

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