[JOINT COMMITTEE PRINT]

OVERVIEW OF TAX-FAVORED RETIREMENT ARRANGEMENTS

FOR THE USE

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AND THE

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INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the Subcommittee on Social Security and the Subcommittee on Oversight of the House Committee on Ways and Means. The subcommittees have scheduled a joint hearing on July 18, 1985, on retirement income security in the United States. This pamphlet provides an overview and description of present law tax provisions relating to the tax treatment of pensions and deferred compensation arrangements.

The first part of the pamphlet is a summary of tax-favored retirement arrangements. The second part describes the treatment of tax-favored savings. The third part describes minimum standards for and coverage of qualified plans. Part four describes distributions of benefits under certain tax-favored retirement arrangements, and part five describes the tax deferral under qualified plans. This pamphlet does not contain a description of the rules relating to employee stock ownership plans (ESOPs).

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Overview of Tax-Favored Retirement Arrangements*, (JCS-24-85), July 17, 1985.

I. SUMMARY OF TAX-FAVORED RETIREMENT ARRANGEMENTS

Background

Under the Federal income tax system, individuals generally are taxed on income as it is earned. This principle has been applied to tax income that is made available (constructively received) in addition to income actually received. In addition, as a general matter, the gross income of a taxpayer generally includes noncash items that are equivalent to cash.

Historically, exceptions to the doctrine of constructive receipt have been adopted by the Congress in order to encourage certain retirement savings by taxpayers. In particular, taxpayers have been encouraged by the tax law to set a part of their compensation aside under current programs that are designed to replace compensation upon retirement. Present law provides incentives by permitting taxpayers to postpone income tax on current compensation set aside for retirement, and on investment earnings on those savings, under special plans of deferred compensation. Under these plans, income tax is generally postponed until the time benefits are paid, even though the benefits (if funded and nonforfeitable) would be considered constructively received or equivalent to cash.

Since 1921, 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.[2] The 1926 Code provided a similar exemption for qualified pension trusts and established deduction limits designed to set appropriate limits on the extent to which tax-favored treatment would be available under qualified plans.[3]

The standards for plan qualification have been revised and expanded since 1921 to reflect Congressional interest in the expansion of pension and profit-sharing plans and concern over tax abuses. The rules relating to qualified plans were substantially revised by the Employee Retirement Income Security Act of 1974 (ERISA), which added (1) minimum coverage, vesting, benefit accrual, and funding requirements, and (2) overall limits on contributions and benefits. That Act also provided for insurance of some benefits under certain plans by the Pension Benefit Guaranty Corporation (PBGC).

In addition to the deferral of income tax on amounts contributed to a qualified plan, present law provides an exclusion from employment taxes (FICA and FUTA) for the amounts deferred under and the benefits paid from a qualified plan. Present law also provides

[2] Sec. 219(f) of the Revenue Act of 1921.
[3] Sec. 219(f), sec. 23(p) of the Revenue Act of 1921.

relief from the effect of graduated tax rates on lump sum distributions by providing special income averaging rules.

Types of tax-favored retirement arrangements

Qualified plans

Under a plan of deferred compensation that meets the qualification standards of the Internal Revenue Code (a qualified plan), an employer is allowed a deduction for contributions (within limits) to a trust to provide employee benefits. Similar rules apply to plans funded with annuity contracts. A qualified plan may be a pension, profit-sharing, or stock bonus plan.

An employer's deductions and an employee's benefits under a qualified plan may be limited by reference to the employee's compensation. The Code also imposes overall limits on benefits or contributions that may be provided under qualified plans. In addition, subject to limits similar to the rules for individual retirement accounts, certain employee contributions may be deductible when made. Investment earnings on the assets of a qualified plan are generally exempt from income tax until distributed.

Under a qualified plan, employees generally do not include benefits in gross income until the benefits are distributed even though the plans are funded and the benefits are nonforfeitable. Tax deferral is provided under qualified plans from the time contributions are made until the time benefits are received.

Benefits or contributions under a qualified plan are subject to standards designed to prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated. In addition, qualified plans are required to meet minimum standards relating to coverage (what employees participate in the plan), vesting (the time at which an employee's benefit becomes nonforfeitable), and benefit accrual (the rate at which an employee earns a benefit). Also, minimum funding standards apply to the rate at which employer contributions are required to be made in order to ensure the solvency of pension plans.

A qualified pension plan may be either a defined benefit pension plan or a money purchase pension plan. Under a defined benefit plan, benefits levels are specified under a plan formula and are not solely dependent on the balance of an account for the employee. For example, a defined benefit plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit plan may also be specified as a flat or step-rate percentage of the employee's average compensation or career compensation. Benefits under a private defined benefit plan are generally guaranteed (within limits) by the Pension Benefit Guaranty Corporation (a Federal corporation).

Under a money purchase pension plan, the amount of employer contributions allocated to an employee must be fixed or determinable. Under a pension plan, benefits are payable in the event of death, disability, separation from service, or retirement.

Under a profit-sharing plan, employer contributions are provided out of current or accumulated profits of the employer. Benefits under a profit-sharing plan can generally be distributed to an employee who has not separated from service. Under a stock bonus plan, contributions may be made under a fixed formula or they may be related to profits of the employer. The rules for stock bonus plans generally require that benefits be distributed in the form of employer stock. Under a stock bonus plan, benefits can generally be distributed to an employee who has not separated from service.

Coverage under employer pension plans in the United States increased from approximately 15 percent of the nonagricultural workforce in 1940 to 41 percent in 1960. Since 1960, it has increased at a much slower rate so that, by 1983, 48.5 percent of the nonagricultural workforce (or 44.3 million workers) was covered by a plan. Table 1, below, shows the distribution of coverage under pension plans by compensation levels for 1983.

Table 1.—Distribution of Total Nonagricultural Wage and Salary Workers With Employer Pension Plans, 1983

Wage and salary class	Total wage and salary workers (thousands)	Workers with employer-provided pension plan	
		Number (thousands)	Percent of workers
Less than $5,000	17,766	1,568	8.8
$5,000 to $10,000	16,961	4,908	28.9
$10,000 to $20,000	29,926	17,405	58.2
$20,000 to $30,000	16,103	12,216	75.9
$30,000 to $50,000	8,544	6,672	78.1
Over $50,000	2,088	1,529	73.2
Total	91,388	44,298	48.5

Source: Office of Tax Analysis, U.S. Treasury and 1984 Current Population Survey (reported data at 1983 levels).

Little or no data are available concerning the extent to which individuals who are participating in employer-provided plans actually receive benefits. Some participants will terminate employment with their employers before vesting in any accrued benefits. Other participants will remain with an employer long enough to obtain vested rights, but their benefits will be partially or fully offset by social security benefits (through social security integration) considered to be provided by their employers.

Tax-sheltered annuities

Tax-sheltered annuity programs may be established by public educational institutions and certain tax-exempt organizations (including churches and other organizations described in Code sec. 501(c)(3)) to provide retirement benefits to employees. Amounts paid by such an employer to purchase a tax-sheltered annuity (which may consist of shares of a regulated investment company (a mutual fund or a closed-end investment company)) are excluded (within limits) from the gross income of an employee even though the employee has a nonforfeitable right to benefits. Tax is also deferred on the investment earnings under a tax-sheltered annuity program.

Tax-sheltered annuities may provide for nonexcludable employee contributions. Also, subject to rules similar to those provided for individual retirement accounts, certain employee contributions may be deducted by an employee. The limits on exclusions under tax-sheltered annuity programs are higher than those for qualified plans.

Tax-sheltered annuity programs are not subject to standards that prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated.

Unfunded governmental plans

Special limits and restrictions apply with respect to unfunded plans of deferred compensation maintained by State and local governments. These limits were considered to be appropriate because, in the case of a governmental employer, the usual tension between the employee's desire to defer tax on compensation and the employer's desire to obtain current deductions is not present. The restrictions are designed to restrain nonretirement use of the deferred amounts. The limits applicable to unfunded governmental plans are coordinated with the limits for tax-sheltered annuities, but are not coordinated with the limits for qualified plans.

Individual retirement arrangements (IRAs)

An individual is allowed a deduction for contributions (within limits) to provide retirement benefits under an individual retirement account or an individual retirement annuity (an IRA). Deductions are limited by reference to the individual's compensation. An individual is generally not taxed on amounts held by an IRA, including investment earnings, until benefits are distributed. Tax deferral is provided during the period between the contribution of compensation and the receipt of benefits. Amounts held by an IRA are subject to restrictions designed to restrain nonretirement use of these funds.

For tax year 1983, contributions to IRAs totaled $32 billion. This total includes deductible contributions and tax-free rollovers. The following table shows the percent of total IRA contributions by adjusted gross income class for 1983. In the table, the "Percentage Distribution" columns show the aggregate contributions for each class as a percentge of aggregate contributions for all classes.

Table 2.—Number of Returns and Amount of Payment to IRAs Distributed by Adjusted Gross Income Class, 1983

Adjusted gross income class	Number of eligible returns [1] (thousands)	Returns			Amount of payment		
		Number (thousands)	As a percent of eligible returns	Percent distributed	Total amount (millions)	Percent distributed	Average amount
Less than $10,000	27,992	645	2.30	4.70	$1,024	3.17	$1,588
$10,000 to $20,000	21,297	2,010	9.44	14.65	3,648	11.28	1,815
$20,000 to $30,000	14,781	2,945	19.92	21.46	6,028	18.63	2,047
$30,000 to $40,000	9,814	2,860	29.14	20.84	6,804	21.03	2,379
$40,000 to $50,000	4,778	2,140	44.79	15.60	5,638	17.43	2,635
$50,000 to $100,000	3,979	2,558	64.29	18.64	7,536	23.30	2,946
$100,000 to $200,000	523	431	82.41	3.14	1,292	3.99	2,998
$200,000 or more	164	130	79.27	.95	377	1.17	2,900
Total	83,326	13,721	16.47	100.00	32,348	100.00	2,358

[1] Eligible returns are returns with wage and salary income.

Source: Statistics of Income, Advanced Data 1983.

II. TREATMENT OF TAX-FAVORED SAVINGS

A. Individual Retirement Arrangements (IRAs)

The individual retirement savings provisions of the Code were originally enacted in the Employee Retirement Income Security Act of 1974 (ERISA) to provide a tax-favored retirement savings arrangement to individuals who were not covered under a qualified plan or a governmental plan maintained by their employer. Those who were active participants in employer plans were not permitted to make deductible IRA contributions.

In the Economic Recovery Tax Act of 1981 (ERTA), Congress eliminated the provision restricting IRA eligibility to individuals who were not active participants and increased both the dollar and percentage limits applicable to annual IRA deductions. Thus, the deduction limit was increased, from the lesser of 15 percent of compensation or $1,500, to the lesser of 100 percent of compensation or $2,000.

Under present law (Code sec. 219), an individual generally is entitled to deduct from gross income the amount contributed to an IRA within certain limits. The limit on the deduction for a taxable year generally is the lesser of $2,000 or 100 percent of compensation (earned income, in the case of income from self-employment).

Under a spousal IRA, an individual is allowed an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year; (2) the spouse has not attained age 70½; and (3) the couple files a joint income tax return for the year. If deductible contributions are made (1) to an individual's IRA and (2) to an IRA for the noncompensated spouse of the individual (a spousal IRA), then the annual deduction limit on the couple's joint return is increased to the lesser of $2,250 or 100 percent of compensation includible in gross income. The annual contribution may be divided as the spouses choose, so long as the contribution for neither spouse exceeds $2,000.

Amounts withdrawn from an IRA prior to the attainment of age 59½, death, or disability of the owner of the IRA are subject to a 10-percent additional income tax (sec. 408(f)). This tax is designed to encourage the use of IRAs as long-term retirement savings programs. (See, also, "Distribution of Benefits under Qualified Plans," in Part IV., below.)

Under present law, interest on indebtedness generally is not deductible if the indebtedness is incurred or continued to purchase tax-exempt obligations (sec. 265). However, if an individual borrows money to make an IRA contribution, the interest paid on the loan is deductible even though the income on the account is not taxed until the amounts contributed are withdrawn.

B. Qualified Cash or Deferred Arrangements

Background

Before the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), some employers permitted employees to decide whether to accept compensation in cash or to defer the compensation by having the employer contribute it to a profit-sharing plan. The Internal Revenue Service raised questions as to whether, under the usual principles of constructive receipt, employees who could have received cash, but chose to defer compensation, should be taxed as though they had received the cash. ERISA provided a limited moratorium on the issuance of Treasury regulations and IRS rulings relating to the application of the constructive receipt rule to employee deferrals under qualified plans. The moratorium was extended until 1978, when the Congress enacted special rules relating to qualifed cash or deferred arrangements. Under those rules, if the requirements of the Code are met, an employee can choose deferral of compensation (within limits) without being taxed as though it had been received.

If a tax-qualified profit-sharing or stock bonus plan (and certain pre-ERISA money purchase pension plans) meets certain requirements (a "qualified cash or deferred arrangement"), then an employee is not required to include in income any employer contributions to the plan merely because the employee could have elected to receive the amount contributed in cash.

Nondiscrimination requirements

The amount a highly paid employee can elect to defer, tax free, under a qualified cash or deferred arrangement depends (in part) on the level of elective deferrals by other employees. Special nondiscrimination tests apply a limit on elective deferrals by the group of highly paid employees that is determined by reference to deferrals by other employees. An employee is considered highly paid, for this purpose, if the employee is one of the highest paid ⅓ of all employees.

The tests are based on the relationship of the average deferral percentage for the group of highly paid employees to the average deferral percentage for the group of other employees. The deferral percentage for an employee for a year is the percentage of that employee's compensation that has been electively deferred for the year. The average deferral percentage for a group of employees is the sum of the deferral percentages for the employees divided by the number of employees in the group.

A cash or deferred arrangement meets these special nondiscrimination requirements for a plan year if (1) the actual deferral percentage for the highly paid employees does not exceed the actual deferral percentage for the other eligible employees by more than 150 percent, or (2) the actual deferral percentage for the highly paid employees does not exceed the actual deferral percentage of the other eligible employees by more than 3 percentage points. If the 3-percent test is used, the actual deferral percentage for the highly paid employees also cannot exceed the actual deferral percentage of all other eligible employees by more than 250 percent. In calculating these deferral percentages, nonelective contributions by the employer that (1) are nonforfeitable when made and (2) satisfy the withdrawal restrictions applicable to elective deferrals may be taken into account as elective deferrals by employees.

The special nondiscrimination tests applicable to cash or deferred arrangements apply in lieu of the usual nondiscrimination rules for qualified plans, which permit employer contributions to social security to be taken into account. These special nondiscrimination rules do not replace the usual rules requiring that a qualified plan cover either a specified percentage of employees or a fair cross section of employees.

The following table shows the maximum deferral by the highly paid employees given different deferrals by all other eligible participants:

Table 3.—Present Law Deferral Limits Applicable to Cash or Deferred Arrangements

[Percent of compensation]

Deferrals by lower two-thirds employees	Maximum deferral for top one-third employees
1.0	2.5
2.0	5.0
3.0	6.0
4.0	7.0
5.0	8.0
6.0	9.0
7.0	10.5
8.0	12.0
9.0	13.5
10.0	15.0
11.0	16.5
12.0	18.0
13.0	19.5
14.0	21.0
15.0	22.5

Withdrawal restrictions

Under present law, a participant in a qualified cash or deferred arrangement is not permitted to withdraw elective deferrals (and earnings thereon) prior to age 59½, death, disability, separation from service, or the occurrence of a hardship.

Limit on elective deferrals

Elective deferrals under a qualified cash or deferred arrangement are subject to the general limits on contributions to a defined contribution plan. Thus, under present law, the elective deferrals generally cannot exceed the lesser of $30,000 or 25 percent of the participant's compensation.

C. Unfunded Deferred Compensation Arrangements of State and Local Governments

Under a general principle of the Federal income tax system, individuals are currently taxed not only on compensation actually received, but also on compensation constructively received during the taxable year. A special provision of present law exempts from this general principle certain amounts deferred under an eligible unfunded deferred compensation arrangement of a State or local government (sec. 457).

Under an eligible State or local deferred compensation plan, an employee who elects to defer the receipt of current compensation will be taxed on the amounts deferred when they are paid or made available. The maximum annual deferral under such a plan is the lesser of (1) $7,500 or (2) 33⅓ percent of compensation. Amounts deferred under a tax-sheltered annuity are taken into account in calculating whether an employee's deferrals exceed the limits.

In general, amounts deferred under an eligible deferred compensation plan may not be made available to an employee prior to separation from service with the employer. In addition, distributions under the plan are required to commence no later than 60 days after the later of (1) the year in which the employee attains normal retirement age or (2) the year in which the employee separates from service. Amounts that are made available to an employee upon separation from service are includible in gross income in the taxable year in which they are made available.

Under an eligible deferred compensation plan, an employee is required to receive benefits in a form which: provides that the amount payable during an employee's lifetime is projected to exceed 50 percent of the total amounts payable with respect to the employee. This rule is similar to the incidental benefit rule applicable to benefits under qualified plans.

Deferrals under a plan that is not an eligible State or local deferred compensation plan (other than a qualified State judicial plan) are includible in an employee's gross income when the amounts are not subject to a substantial risk of forfeiture.

III. MINIMUM STANDARDS FOR QUALIFIED PLANS

A. Coverage

Since 1921, the Code has 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 designed to set appropriate limits on the extent to which tax-favored treatment would be available under qualified plans.

The standards for plan qualification have been revised and expanded since 1921 to reflect Congressional interest in the expansion of pension and profit-sharing plans and concern over perceived tax abuses. A nondiscrimination standard was added to the qualification requirements by the Revenue Act of 1942. The nondiscrimination standard prohibited discrimination in favor of specified employees.

In 1942, the Treasury Department, noting the tax avoidance potential of pension trusts,[4] recommended that tax benefits be provided only with respect to those plans that cover a substantial number of employees and that provide nondiscriminatory benefits. The Report on the 1942 Act indicates that the prior law had "been considerably abused by the use of discriminatory plans that either cover only a small percentage of the employees or else favor the higher paid or stock-holding employees as against the lower paid or nonstock-holding employees . . ." [5] The 1942 Act provided standards designed to prevent qualified plans from unduly benefiting employees who are officers, supervisors, shareholders, or highly compensated (generally referred to as highly compensated employees). That Act included provisions intended to prevent a plan from qualifying if it failed to cover a fair cross-section of the employees of an employer. In addition, the Act prohibited contributions or benefits under a qualified plan from discriminating in favor of employees who are highly compensated.

As subsequently modified by the Employee Retirement Income Security Act of 1974 (ERISA), those coverage requirements (Code sec. 410(b)) continue to require that a plan cover employees in general rather than merely the employer's top-ranking employees. A plan generally satisfies the present-law coverage rule if (1) it benefits a significant percentage of the employer's workforce (percentage test), or (2) it benefits a classification of employees determined

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[4] See, e.g., the statement of Treasury Secretary Randolph Paul before the House Committee on Ways and Means, March 3, 1942; see, also, Mr. Paul's memorandum of March 23, 1942, introduced into the Hearing Record at p. 1004.
In addition, see Mr. Paul's testimony before the Senate Committee on Finance, July 23, 1941 (p. 95).

[5] H. Rpt. 2333, 77th Cong. 2d Sess. 51 (1942).

by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (fair cross-section test).

Percentage tests

A plan meets the percentage test if (1) it benefits at least 70 percent of all employees, or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

Fair cross-section test

A plan meets the classification test if the Secretary of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders, or highly compensated. In making that determination, the Secretary is required to consider all the surrounding facts and circumstances, allowing for a reasonable difference between the ratio of highly compensated employees who are benefited by the plan to all such employees and the corresponding ratio calculated for employees who are not highly compensated. Factors specifically to be considered include whether the compensation of plan participants is substantially the same as that of excluded employees, whether the plan covers employees in all compensation ranges, and whether employees in the middle and lower-compensation brackets are covered in more than nominal numbers.[6]

Excludable employees

In applying the percentage test, certain employees who have not yet completed one year of service and employees who have not yet attained age 21 may be disregarded if they are excluded pursuant to a plan provision. In addition, in applying both the percentage and the fair cross-section tests, employees covered by certain collectively bargained plans, certain nonresident aliens and certain airline employees must be disregarded.

Tax-sheltered annuities

Under present law, the coverage tests do not apply to tax-sheltered annuities.

B. Vesting

In general

Prior to the enactment of the Employee Retirement Income Security Act of 1974 (ERISA), a qualified plan was required to provide vested (i.e., nonforfeitable) rights to employees when they attained the normal or stated retirement age. Qualified plans were also required to vest employees upon plan termination or the discontinuance of employer contributions. However, no preretirement vesting was required unless the absence of such vesting caused discrimination in favor of officers, shareholders, supervisors, or highly compensated employees.

[6] *See,* e.g., Rev. Rul. 83-58, 1983-1 C.B. 95.

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, ERISA generally requires: (1) that a participant's benefits be fully vested upon attainment of normal retirement age; (2) that a participant be fully vested at all times in the benefit derived from employee contributions; and (3) that employer-provided benefits vest at least as rapidly as under one of three alternative minimum vesting schedules (sec. 411(a)). Under these schedules, an employee's right to benefits derived from employer contributions becomes nonforfeitable (vested) to varying degrees upon completion of specified periods of service with an employer.

Under one of the schedules, full vesting is required upon completion of 10 years of service (no vesting is required before the end of the 10th year). Under a second schedule, vesting begins at 25 percent after completion of five years of service and increases gradually to 100 percent after completion of 15 years of service. The third schedule takes both age and service into account, but in any event, requires 50-percent vesting after 10 years of service, and an additional 10-percent vesting each year thereafter until 100-percent vesting is attained after 15 years of service.

Patterns of discrimination

Prior to ERISA, accelerated vesting (i.e., vesting before normal retirement age) was sometimes imposed on a qualified plan to prevent discrimination. Although ERISA required all qualified plans to meet certain minimum preretirement vesting standards, accelerated vesting may still be required to prevent discrimination if (1) there has been a pattern of abuse under the plan tending to discriminate in favor of employees who are officers, shareholders, or highly compensated; or (2) there has been, or there is reason to believe there will be, an accrual of benefits or forfeitures tending to discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 411(d)(1)).

Top-heavy plans

In addition, the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) required accelerated vesting for certain top-heavy plans to improve the likelihood that covered participants would receive benefits.[7] For any plan year for which a qualified plan is top-heavy, an employee's right to accrued benefits must become nonforfeitable under one of two alternative schedules. Under the first top-heavy plan schedule, a participant who has completed at least three years of service with the employer maintaining the plan must have a nonforfeitable right to 100 percent of the accrued benefit derived from employer contributions.

A plan satisfies the second alternative (six-year, graded vesting) if a participant has a nonforfeitable right to at least 20 percent of the accrued benefit derived from employer contributions at the end of two years of service, 40 percent at the end of three years of service, 60 percent at the end of four years of service, 80 percent at the

[7] A top-heavy plan is one under which more than 60 percent of the benefits are provided for key employees (sec. 416).

end of five years of service, and 100 percent at the end of six years of service with the employer.

Class year plans

Special vesting rules also apply to "class year plans" (sec. 411(d)(3)). A class year plan is a profit-sharing or stock bonus plan that provides for the separate vesting of employee rights to contributions on a year-by-year basis. The minimum vesting requirements are satisfied if the plan provides that a participant's right to contributions with respect to any plan year are nonforfeitable not later than the close of the fifth plan year following the plan year for which the contribution was made.

C. Integration

In general

The Code provides nondiscrimination standards for qualified pension, profit-sharing, and stock bonus plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees). Under these standards, coverage tests are applied to determine whether the classification of employees who participate in a plan is discriminatory. Additional tests are applied to determine whether contributions or benefits under the plan discriminate in favor of highly compensated employees.

The rules prohibiting discrimination under qualified plans were adopted by the Congress in 1942. The nondiscrimination standard was adopted to "safeguard the public against the use of the pension plan as a tax-avoidance device by management groups seeking to compensate themselves without paying their appropriate taxes." [8] Congress was concerned that the requirement of nondiscriminatory coverage by a plan was not sufficient. Although nondiscriminatory coverage could assure that rank-and-file employees were not unfairly omitted from a plan, it could not assure that those employees would be provided with a fair share of benefits. Accordingly, the 1942 Act included standards requiring that a qualified plan provide nondiscriminatory benefits or contributions for plan participants. It was noted that even ". . . extended coverage would not by itself guarantee that the pension plan would be operated for the welfare of employees generally, because the scale of benefits could be manipulated. Therefore, the scale of benefits must be nondiscriminatory." [9] In determining whether benefits were discriminatory, the Congress noted that plans designed in good faith to supplement social security should be permitted to qualify for favorable tax treatment.[10] Thus, a plan that provides benefits which, when aggregated with employer-provided social security benefits, constitute a nondiscriminatory percentage of compensation, is deemed to be nondiscriminatory even though plan benefits standing alone would not meet the nondiscrimination standard.

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[8] H. Rpt. 77-2333, 77th Cong. 2d Sess. 51 (1942).
[9] Ibid.
[10] See, e.g., S. Rpt. 1631, 77th Cong. 2d. Sess. 139 (1942).

Integration of defined benefit pension plans

Generally, in applying the nondiscrimination test to benefits under a plan, the rate at which benefits are provided by the plan for highly compensated participants (as a percentage of their pay) is compared with the rate at which the plan provides benefits for other participants. A plan fails the nondiscrimination standard if both benefits and contributions discriminate in favor of highly compensated employees.

Under present law, in determining whether defined benefit pension plan benefits, as a percentage of nondeferred pay, discriminate in favor of employees who are highly compensated, the portion of each employee's social security benefits paid for by the employer may be taken into account. For this purpose, social security benefits mean old age, survivors, and disability insurance (OASDI) benefits provided under the social security system.

A plan that meets the nondiscrimination standards of the Code only if social security benefits are taken into account is referred to as an integrated plan. If these social security benefits and the employer-provided benefits under the plan, when added together, provide an aggregate benefit that is a higher percentage of pay for highly compensated employees than for other employees, then the benefits under the plan are discriminatory and the plan does not qualify. Either benefits or contributions under a plan may be integrated.

Two basic approaches to integration of defined benefit pension plans have been developed—(1) the "offset" approach, and (2) the "excess" approach.[11]

(1) Offset plans

A defined benefit pension plan that integrates under the offset approach is referred to as an offset plan. An offset plan initially provides each employee with an annual pension benefit that (as a percentage of pay) does not discriminate in favor of highly compensated employees. For each employee, this initial benefit is then reduced, or offset, by the employer-provided portion of that employee's social security benefit to arrive at the actual pension benefit under the plan.

In 1971, the Internal Revenue Service determined that the value of employer-provided social security benefits is equal to 83⅓ percent of the annualized primary insurance amount (PIA) to which an employee is entitled under the Social Security Act. Consequently, an offset plan could integrate its benefits with social security by providing each employee an annual benefit of, for example, 50 percent of pay offset by 83⅓ percent of the employee's PIA.

(2) Excess plans

A pension plan that integrates under the excess approach is referred to as an excess plan. The basic theory underlying the excess approach is that social security provides benefits based on only a certain portion of an employee's earnings. An excess plan is de-

[11] Rules for integrating under these two approaches are set forth in Rev. Rul. 71-446, 1971-2 C.B. 187.

signed to provide benefits (or added benefits) based on the portion of an employee's earnings "in excess" of the earnings on which social security benefits are provided (covered compensation). An excess plan integrates if the benefits it provides with respect to compensation in excess of covered compensation are not greater, as a percentage of pay, than the benefits provided by social security on covered compensation.

In 1971, the Internal Revenue Service determined that the employer-provided portion of benefits under social security averages 37½ percent of the average maximum pay on which social security benefits are based. Consequently, for an employee retiring at age 65 in 1985, an excess plan will integrate properly if it provides benefits at a rate no greater than 37½ percent of pay in excess of $13,800 (approximately the highest average annual wage upon which social security benefits can be based for such an employee), although it provides no benefits with respect to the first of $13,800 pay.

If an excess plan provides benefits on compensation up to covered compensation, then it can provide benefits at a higher rate on pay above the level of covered compensation. However, the rate at which benefits are provided above covered compensation cannot exceed the rate at which benefits are provided on compensation up to covered compensation by more than 37½ percent. For example, an integrated excess plan could provide benefits at the rate of 12½ percent for all compensation plus 50 percent (i.e., 37½ percent plus 12½ percent) of compensation in excess of covered compensation.

Integration of defined contribution plans

Defined contribution plans do not provide specified benefit formulas. Defined contribution plans provide for contributions to be allocated to and accumulated in a separate account for each employee. Accordingly, such plans are integrated by taking into account the employer-paid portion of social security taxes. Specifically, a defined contribution plan is integrated by reducing contributions to the plan with respect to the portion of an employee's pay subject to the social security tax (i.e., the taxable wage base).

Prior to 1984, the integration of a defined contribution plan was based on the IRS-calculated cost of employer-provided social security benefits. For pre-1984 years, the Internal Revenue Service had determined that the employer's cost of providing social security benefits was seven percent of pay subject to the tax.

Effective for plan years beginning after 1983, TEFRA revised the integration rules for profit-sharing and other defined contribution plans. TEFRA permits an employer to reduce plan contributions on behalf of an employee by no more than an amount equal to the employee's taxable wage base multiplied by the actual OASDI tax rate. Thus, a profit-sharing plan could provide contributions of 5.7 percent (the OASDI tax rate of 1985 pay in excess of $39,600 (the 1985 taxable wage base) and no contributions for 1985 with respect to the first $39,600 of pay. Similarly, if a plan provided for 1985 contributions of 10 percent of pay in excess of $39,600, it would integrate properly only if it provided for 1985 contributions of at least 4.3 percent with respect to the first $39,600 of pay.

Top-heavy plans

A qualified plan that is top heavy must provide a minimum nonintegrated benefit or contribution derived from employer contributions for each employee who is a participant in the plan and who is not a key employee (sec. 416).[12] The rule is designed to reflect the higher proportion of tax benefits focused on key employees in a top-heavy plan.

A defined benefit pension plan satisfies this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant who is not a key employee, when expressed as an annual retirement benefit, is not less than two percent of the employee's average annual compensation from the employer, 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. This required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits attributable to contributions by the employer (i.e., the minimum benefit is a "nonintegrated" benefit).

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 three percent of the participant's compensation. The minimum contribution must be made for each year in which the plan is top heavy. However, special rules provide that if the employer's contribution rate for each participant who is a key employee for the plan year is less than three percent, then the required minimum contribution rate for each non-key employee generally is limited to the highest contribution rate for any key employee.

Amounts paid by the employer for the year to provide social security benefits for the employee are disregarded. Thus, the required minimum contribution for a non-key employee may not be eliminated or reduced on account of benefits attributable to social security taxes paid by the employer (i.e., the minimum contribution is a "nonintegrated" contribution).

D. Top-Heavy Plans

In general

For years beginning after December 31, 1983, TEFRA provides additional qualification requirements for plans that primarily benefit an employer's key employees (top-heavy plans). These additional requirements (1) limit the amount of a participant's compensation that may be taken into account, (2) provide greater portability of benefits for plan participants who are non-key employees by requiring more rapid vesting, (3) provide minimum nonintegrated contributions or benefits for plan participants who are non-key employees, and (4) reduce the aggregate limit on contributions and benefits for certain key employees (sec. 416).

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[12] Generally, a plan is top heavy if more than 60 percent of the benefits it provides are for key employees (sec. 416).

Top-heavy calculation

A defined benefit pension plan is generally top heavy for a year if, as of the determination date, the present value of the cumulative accrued benefits for participants who are key employees for the year exceeds sixty percent of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan is a top-heavy plan for a year if, as of the determination date, the sum of the account balances of participants who are key employees for the plan year exceeds sixty percent of the sum of the account balances of all employees under the plan.

Accrued benefits

In general, a defined benefit pension plan will not be considered a qualified plan unless participants accrue benefits at a rate that meets one of three alternative schedules (sec. 411(b)).

Under the first alternative, known as the "three-percent rule," a plan participant must accrue a benefit during each year of participation (up to 33⅓ years) not less than three percent of 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 "133⅓-percent rule," a plan will satisfy the accrued benefit requirements if the accrued benefit of a plan participant, as of his normal retirement age, is equal to the normal retirement benefit under the plan, and the annual rate at which any individual, who is or could be a plan participant accruing the retirement benefits in any year, is never more than 133⅓ 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 annually until normal retirement age the same rate of compensation. 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.

Under the top-heavy rules, benefits promised and accrued under the plan's benefit formula must be at least equal to the required minimum benefit. Although the top-heavy plan rules do not prescribe specific accrual rules, the definition of the required minimum benefit overrides the scheduled accruals (sec. 411(b)), essentially accelerating or front loading the accrual rate.

IV. DISTRIBUTION OF BENEFITS UNDER CERTAIN TAX-FAVORED RETIREMENT ARRANGEMENTS

The rules for certain tax-favored retirement arrangements include provisions designed to encourage the retention of savings until retirement and to require that payment of benefits take place during retirement years. These rules are structured to focus the greatest benefit of tax-favored treatment on amounts actually set aside for retirement and to limit the extent to which tax benefits are available for other savings held under the arrangement.

Under a qualified pension plan, benefits may be distributed on account of an employee's separation from service, disability, or death. In-service distributions are not permitted under a qualified pension plan before retirement age.

Withdrawals from savings under qualified profit-sharing or stock bonus plans are subject to less restriction than withdrawals under qualified pension plans. Qualified profit-sharing or stock bonus plans may generally permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years) or after the occurrence of a stated event (e.g., hardship). Hardship distributions may also be permitted under a tax-sheltered annuity. Plans to which the less restrictive withdrawal rules apply have been referred to as capital accumulation or savings plans.

Special restrictions apply to benefits under a qualified cash-or-deferred arrangement (a sec. 401(k) plan) that is part of a profit-sharing or stock bonus plan. Generally, except for hardship, these benefits may not be distributed before an employee attains age 59½ or separates from service.

The Code does not provide restrictions on benefit distributions under most private nonqualified plans of deferred compensation. However, benefits under unfunded deferred compensation plans of State or local governments are not permitted to be paid earlier than when the employee separates from service or is faced with an unforseeable emergency. (See Part II.C., "Unfunded Deferred Compensation Arrangements of State and Local Governments.")

A. Minimum Distribution Rules

Before-death distributions

The Code imposes a minimum distribution requirement with respect to retirement savings under qualified plans. The minimum distribution requirement is designed to require that tax-favored retirement savings are withdrawn during retirement years and to restrict the use of these accumulations for estate planning purposes (i.e., to transfer wealth to another generation). Under the Code, the minimum requirement is met if the entire interest of an employee is distributed no later than a specified date (the required beginning date). The Code provides, however, that the minimum distribution requirement may also be met if the entire interest of an employee is to be distributed no more slowly than under certain extended distribution alternatives. Because the primary purpose of a pension plan is the payment of benefits after retirement, any nonretirement benefits (including death benefits) provided by such a plan must be no more than incidental to the plan's retirement benefits.

The Code specifies that distributions made over certain permissible periods if benefit payments are substantially nonincreasing and begin no later than the required beginning date. Under the Code, the period for distribution of such a benefit may be (1) the life of the employee, (2) the lives of the employee and a designated beneficiary, (3) a period (which may be a term certain), not extending beyond the life expectancy of the employee, or (4) a period (which may be a term certain) not extending beyond the life expectancy of the employee and a designated beneficiary (an individual designated by the employee).

After-death distributions

The Code provides a minimum distribution requirement with respect to benefits payable from a qualified plan with respect to a participant who has died. The applicable rules depend upon whether benefits commenced before or after the employee's death.

Under the Code, if benefits commenced to the employee before death, then the remaining portion of the employee's interest is to be distributed at least as rapidly as under the method of distribution in effect prior to death.

If benefits did not commence before the death of the employee, then the Code requires that the entire interest of the employee is to be distributed within 5 years after the date of death unless the after-death distribution method meets certain requirements. Under the Code, the 5-year distribution requirement does not apply to the portion of an employee's after-death remaining interest payable to a designated beneficiary that will be distributed over the life of the designated beneficiary (or over a period (including a term certain) not extending beyond the life expectancy of the beneficiary) if (1) those distributions will commence no later than 1 year after the date of death, and (2) the distributions are paid to the designated beneficiary under rules that meet the minimum distribution requirements for before-death distributions.

A second exception to the 5-year distribution requirement applies if the designated beneficiary is the surviving spouse of the employee.

Tax-sheltered annuities and IRAs

Present law provides after-death minimum distribution requirements for tax-sheltered annuities and IRAs corresponding to the rules for qualified plans. A 50-percent excise tax applies to amounts required to be distributed from an IRA that are not distributed.

Nonqualified plans of deferred compensation

The minimum distribution requirements do not apply to private or public unfunded plans of deferred compensation.

B. Distributions Before Age 59½

Generally, under present law, a 10-percent additional income tax is imposed on distributions from qualified plans with respect to 5-percent owners who have not attained the age of 59½. The additional tax discourages early withdrawals by recapturing a measure of tax benefits that would otherwise be available. The additional tax does not apply if the distribution is made because of the employee's disability or death. The tax also applies to any withdrawals from an IRA before the owner of the IRA attains age 59½, dies, or becomes disabled.

Under present law, distributions under a tax-sheltered annuity invested in a custodial account (i.e., a mutual fund) may not be withdrawn prior to the time an employee attains age 59½, dies, becomes disabled, separates from service, or encounters financial hardship. Other tax-sheltered annuities are not subject to these withdrawal restrictions. Similarly, distributions from a qualified cash-or-deferred arrangement are not permitted before the participant attains age 59½, dies, becomes disabled, separates from service, or encounters hardship.

C. Tax Treatment of Distributions

Generally, a distribution of benefits from a tax-favored savings arrangement is includible in gross income. In the case of a distribution from a qualified plan or an IRA, such a distribution is includible in the year in which it is paid or distributed. For other arrangements, benefits are includible when paid or made available. The Code provides special tax-free rollover rules designed to encourage the retention of savings under certain retirement programs until retirement.

Under the Code, a lump-sum distribution from a qualified plan may qualify for special 10-year forward income averaging or long-term capital gain treatment. The special treatment of lump-sum distributions was provided to mitigate the effect of graduated tax rates on a distribution with respect to service with an employer of at least 5 years. Further, tax on the unrealized appreciation on employer securities distributed by a qualified plan may be deferred until the securities are sold or exchanged.

Present law provides special rules for the treatment of basis (e.g., employee contributions) when an individual receives a distribution from a tax-favored retirement arrangement. If an amount is received before the annuity starting date (i.e., the date on which an amount is first received as an annuity), then the individual is treated as receiving employee contributions first and taxable income second.

In the case of amounts received after the annuity starting date, each payment received is generally treated as part a return of employee contributions and part taxable income. However, a special rule applies so that, if an individual will receive all employee contributions within the first 3 years after the annuity starting date, then all distributions are treated as a return of employee contributions until all of the individual's basis has been recovered.

D. Tax-Free Rollovers

Special treatment is provided with respect to certain distributions from tax-favored savings arrangements. In the case of a qualified plan, a benefit distribution that meets the requirements of the Code may be rolled over, tax free, to another qualified plan or to an IRA. Similarly, a benefit payment under a tax-sheltered annuity may be rolled over, tax free, to another tax-sheltered annuity or to an IRA if the requirements of the Code are met. Further, if the balance of an IRA is attributable solely to a tax-free rollover of the balance to the credit of the employee under a qualified plan, it may be distributed from the IRA and rolled over to another qualified plan. Similar rules apply with respect to tax-sheltered annuities. Distributions from an IRA to which deductible contributions have been made may be rolled over to another IRA but not to a qualified plan or to a tax-sheltered annuity.

The period during which an amount to be rolled over may be used by a taxpayer before it is returned to a tax-favored retirement program is limited by the Code. The limits are designed to restrict preretirement use of funds with respect to which tax benefits are provided. A rollover generally must be completed within 60 days after a distribution. No more than 1 rollover is permitted from an IRA within a 12-month period.

A rollover of a partial distribution is permitted only if (1) the distribution equals at least 50 percent of the balance to the credit of the employee, determined immediately before the distribution, (2) the distribution is not one of a series of periodic payments, and (3) the employee elects tax-free rollover treatment. A subsequent distribution from the same plan (or from any other plan required to be aggregated with that plan under the lump-sum distribution rules) is not eligible for the special 10-year forward income averaging and long-term capital gain treatment accorded lump-sum distributions. Also, the unrealized appreciation on employer securities distributed from such a plan does not qualify for tax deferral.

E. Loans Under Qualified Plans

An individual is permitted, under present law, to borrow from a qualified plan in which the individual participates, provided the loan 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 employees who are officers, shareholders, or highly compensated (sec. 4975). Interest paid on a loan from a qualified plan is deductible (sec. 163).

Subject to certain exceptions, a loan to a plan participant is treated as a taxable distribution of plan benefits. An exception to this general rule of income inclusion is provided to the extent that the loan (when added to the outstanding balance of all other loans to the participant from all plans maintained by the employer) does not exceed the lesser of (1) \$50,000 or (2) the greater of \$10,000 or one-half of the participant's accrued benefit under the plan. This exception applies only if the loan must, by its terms, be repaid within 5 years or, if the loan is used to acquire or improve a principal residence of the participant or a member of the participant's family, within a reasonable period of time.

V. TAX DEFERRAL UNDER QUALIFIED PLANS

A. Overall Limits On Contributions And Benefits

In general

The Employee Retirement Income Security Act of 1974 (ERISA) added overall limits on contributions and benefits under qualified plans and tax-sheltered annuities (sec. 415). The overall limits apply to contributions and benefits provided to an individual under all qualified plans, tax-sheltered annuities, and simplified employee plans (SEPs) maintained by any private or public employer or by certain related employers. The limits provided by ERISA were automatically adjusted for inflation. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) reduced the limits "to prevent excessive accumulations . . ."[13] and suspended cost-of-living increases.

Defined contribution plans

Under a defined contribution plan, the qualification rules provide an overall limit on the annual addition with respect to each plan participant (Code sec. 415(c)). As originally enacted, the annual addition (consisting of employer contributions, certain employee contributions, and forfeitures allocated from the accounts of other participants) generally was limited to the lesser of (1) 25 percent of compensation for the year, or (2) $25,000, adjusted for cost-of-living increases, as measured by the changes in the consumer price index (CPI) since 1974. By 1982, the dollar limit, as increased to reflect cost-of-living adjustments, was $45,475. In 1982, TEFRA reduced the dollar limit from $45,475 to $30,000.

Defined benefit pension plans

Under a defined benefit pension plan, the pre-TEFRA limit on the annual benefit derived from employer contributions was the lesser of (1) 100 percent of average compensation, or (2) $75,000, adjusted for cost-of-living increases, as measured by the CPI since 1974. By 1982, the dollar limit on annual benefits, as increased to reflect cost-of-living adjustments, was $136,425. In 1982, TEFRA reduced that dollar limit from $136,425 to $90,000.

Prior to TEFRA, the annual benefit generally was the equivalent of an annuity for the life of the participant, beginning at age 55 or later, and determined without regard to certain survivor and nonretirement benefits. If retirement benefits commenced before age 55, the dollar limit was actuarily reduced. TEFRA provided that the new $90,000 limit (but not the 100 percent of compensation limit) is reduced if benefits commence before age 62 (rather than

[13] S. Rpt. 97-494, 97th Cong. 2d Sess., Vol. 1, 314 (1982).

age 55). Thus, for benefits commencing before age 62, the $90,000 limit generally is reduced so that it is the actuarial equivalent of an annual benefit of $90,000 commencing at age 62. In no event, however, is the dollar limit applicable to benefits commencing at or after age 55 less than $75,000. If retirement benefits commence before age 55, the dollar limit is actuarily reduced so that it is the actuarial equivalent of a $75,000 annual benefit commencing at age 55.

The Code provides that reduced limits apply to participants with less than ten years of service. The limits are reduced by ten percent per year for each year of service less than ten. For example, benefits commencing at or after age 62 with respect to a participant who had only three years of service could not exceed 3/10ths of $90,000 ($27,000).

Before TEFRA, the dollar limits were adjusted annually for cost-of-living increases, as measured by the CPI since 1974 (sec. 415(d)). By 1982, the limit on annual additions had increased from $25,000 to $45,475; the limit on annual benefits had increased from $75,000 to $136,425. In addition to lowering these dollar limits (to $30,000 and $90,000, respectively), TEFRA suspended cost-of-living increases in 1983, 1984, and 1985. The Deficit Reduction Act of 1984 (DEFRA) further suspended cost-of-living increases in 1986 and 1987. Beginning in 1988, the $30,000 and $90,000 are scheduled to be adjusted for post-1986 cost-of-living increases.

Employee contributions

Under the Code, only a portion of nondeductible employee contributions to a qualified plan is taken into account in applying the overall limit. The amount taken into account is the lesser of one-half of the employee contributions or total employee contributions in excess of six percent of compensation.

Combined plan limit

The Code also provides an aggregate limit applicable to employees who participate in more than one type of plan maintained by the same employer.

If an employee participates in a defined contribution plan and a defined benefit pension plan maintained by the same employer, the fraction of the separate limit used for the employee by each plan is computed and the sum of the fractions is subject to an overall limit (sec. 415(e)). As originally enacted, the sum of the fractions was limited to 1.4. In 1982, TEFRA redefined the fractions and limited the sum of the two fractions to 1.0. Although the sum of the fractions is 1.0, adjustments made to the denominators of the revised fractions effectively provide an aggregate limit of the lesser of 1.25 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

Aggregate limit on contributions and benefits for key employees in a top-heavy plan

Under present law, the combined plan limit may be reduced for an employee who participates in both a defined benefit pension plan and a defined contribution plan that are top heavy. Unless certain requirements are met, for any year for which the plans are top heavy, the new fractions are modified, effectively providing the key employee with an aggregate limit equal to the lesser of 1.0 (as applied to the dollar limits) or 1.4 (as applied to the percentage of compensation limits).

These modifications do not apply if the plans of the employer in which the key employee participates (1) are not super top heavy (i.e., do not provide more than 90 percent of the benefits for key employees), and (2) provide either an extra minimum benefit (in the case of the defined benefit pension plan) or an extra minimum contribution (in the case of the defined contribution plan) for non-key employees participating in the plans.

Tax-sheltered annuities

Present law provides that employer payments to purchase a tax-sheltered annuity contract for an employee are excluded from gross income to the extent they do not eceed an exclusion allowance. Employer payments to purchase a tax-sheltered annuity contract for an employee are also subject to the overall limits on contributions and benefits under qualified plans (sec. 415). Generally, under the overall limits, annual additions [14] to tax-sheltered annuities and other defined contribution arrangements for the employee may not exceed the lesser of a specified dollar amount, or 25 percent of the employee's compensation from the employer for the year. Under a special rule (sec. 415(c)(4)(C)), an employee of an educational institution, hospital, home health service agency, or church may elect to compute the annual exclusion allowance for payments under a tax-sheltered annuity solely by reference to the maximum annual employer payment that could be made under the overall limit.

In addition, to allow certain lower-paid employees catch-up payments (i.e., payments permitted under the exclusion allowance on account of prior years of service, but denied under the overall annual limit that takes into account only the current year), alternative special elections are provided to increase the overall limit for the year of the election. An individual is allowed only one of the special elections under section 415.[15]

In addition, a church employee may make an additional election pursuant to which the church may make payments for the year in excess of the otherwise applicable overall annual limit.[16] The election may not be made for the same year in which a catch-up election is effective.

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[14] With respect to a tax-sheltered annuity, annual additions consist of employer contributions and certain employee contributions.

[15] The first alternative catch-up election (sec. 415(c)(4)(A)) may be made only for the year of an employee's separation from the service of the contributing employer (the separation year catch-up election). The second alternative catch-up election (sec. 415(c)(4)(B)) generally may be made for any year, but is subject to additional limitations. Neither election increases the amount excludable from the employee's income for the year under the exclusion allowance.

[16] The employee's election increases the overall annual limit to the lesser of (1) the amount paid by the church for the year, or (2) $10,000. Employer payments permitted for a church employee under this provision (i.e., payments in excess of the otherwise applicable annual limits) may not exceed $40,000 for the employee's lifetime. Of course, payments made pursuant to the election are excludable from the employee's income only if they are otherwise permitted under the employee's exclusion allowance for the taxable year.

B. Deductions for Contributions to Qualified Plans

In general

Generally, the contributions of an employer to a qualified plan are deductible in the year for which the contributions are paid, within limits. 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 upon the type of plan to which the contribution is made and may depend upon whether an employee covered by the plan is also covered by another plan of the employer. Under the Code, if a contribution for a year exceeds the deduction limits, then the excess may generally be deducted in succeeding years as a carryover.

Profit-sharing and stock bonus plans

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. Under the Code, 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. On the other hand, if the contribution for a particular year is lower than the deduction limit, then the unused limitation may be carried over and used in later years. In the case of a limitation carryover, the amount deducted in a later year is not to exceed 25 percent of the aggregate compensation of employees covered by the plan during that year.

Defined benefit pension plans

In general

Employer contributions under a defined benefit pension plan are required to meet a minimum funding standard. The deduction allowed by the Code for an employer's contribution to a defined benefit pension plan is limited to the greater of the following amounts:

(1) The amount necessary to meet the minimum funding standard for plan years ending with or within the taxable year.[17]

(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 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, the amount necessary

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[17] Under the minimum funding standard, the normal cost of a plan for a year is required to be funded currently. (The normal cost of a plan for a year is the cost of benefits earned in that year.) Past service costs (for example, the cost of a retroactive benefit increase) are required to be spread over a period of years. (The period depends on the origin of the past service cost and on the funding method used by the plan.) Because the deduction limit is not less than the contribution required by the minimum funding standard, an employer is generally not required by that standard to make a nondeductible contribution.

to amortize those credits in equal annual payments over 10 years. Generally, this rule permits contributions in excess of the contributions required by the minimum funding standard.

Minimum funding

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) are spread over a period of years.

Actuarial assumptions

In computing costs under a defined benefit pension plan, it is necessary to make assumptions with respect to economic conditions and events that will occur in the future. These assumptions, particularly the assumption with respect to interest rates that will prevail in the future, can have a significant effect on estimates of the cost of a plan and on deduction limits with respect to employer contributions to plans. Present law requires that acturial assumptions used in determining the funding requirements of a pension plan be reasonable in the aggregate. Under this standard, reasonableness has been tested on the basis of whether, over a period of time, the actual experience of the plan is materially and consistently different from the assumed experience. Changes in estimated liabilities resulting from changes in actuarial assumptions are taken into account under the minimum funding standard over a 15-year period. Similar treatment is provided for actuarial gains and losses (the difference between estimated experience and actual experience).

Money purchase pension plans

Employer contributions to a money purchase pension plan are generally deductible under the same rules that apply to defined benefit pension plans. Under a qualified money purchase pension plan, the contribution rate specified by the plan is required to be made under the minimum funding standard.

Combination of pension and other plans

If an employer maintains a pension plan (defined benefit or money purchase) and either a profit-sharing or a stock bonus 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 the contribution necessary to meet the minimum funding requirements of the pension plans for the year or 25 percent of the aggregate compensation of employees covered by the plans for the year. Deduction and limitation carryovers are provided.

The limit applies, for example, if an employer maintains both a defined benefit pension plan and a profit-sharing plan for the same employee. It does not apply, however, solely because the employer maintains both a defined benefit plan and a money purchase pension plan for the same employee.

Certain excess contributions

The minimum funding standard includes provisions (the full funding limitation) designed to eliminate the requirement of additional employer contributions under a plan for a period during which it is fully funded. The funding standard, however, does not prohibit employers from making contributions in excess of those required.

Employer contributions in excess of the deduction limits provided by the Code are not currently deductible. A deduction carryover is generally allowed, however, for employer contributions to a qualified plan in excess of the deductible limits.

A pension, profit-sharing, or stock bonus plan does not meet the requirements of the Code for qualified status unless it is for the exclusive benefit of employees and their beneficiaries. Under some circumstances, employer contributions in excess of the level for which a deduction is allowed may indicate that the plan is not for the exclusive benefit of employees. For example, if a defined benefit pension plan is being used as a means of providing an employer with tax deferral, rather than for the exclusive benefit of employees, the plan does not meet the qualification requirements. Continued employer contributions to such a plan under which employer contributions are not required because of the full funding limitation would generally indicate that the plan is being used for purposes other than the exclusive benefit of employees.

C. Asset Reversions from Terminated Plans

In general

A qualified plan must be for the exclusive benefit of employees. Generally, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan are not to be used for, or diverted to, purposes other than the exclusive benefit of employees. Accordingly, if assets remain in a plan as a result of actuarial error, after it has provided all benefits, then those assets may be paid, as a reversion, to the employer. In addition, the Code provides that certain contributions made by mistake may be returned to employers.

Under a qualified defined benefit pension plan, benefit levels are specified under a plan formula and are not solely dependent on the balance of an account for the employee. For example, a defined benefit pension plan might provide a monthly benefit of $10 for each year of service completed by an employee. Benefits under a defined benefit plan may also be specified as a flat or step-rate percentage of the employee's average compensation or career compensation.

Generally, benefits under a tax-qualified, private, domestic, defined benefit pension plan are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (a Federal corporation).

Employer contributions are required to meet the requirements of a minimum funding standard. Employee contributions may be permitted or required under the plan.

Surplus arising from actuarial error

In general.—The Code and ERISA permit an employer to receive a reversion of assets from a terminated defined benefit pension plan where the surplus is due to actuarial error. Generally, a surplus is considered to be due to actuarial error if it is due to differences between projected experience under a plan and actual experience.

Anticipation of future benefit costs.—The funding standard provided by present law requires funding under an acceptable funding method, on a "going concern" basis rather than a "termination" basis. Accordingly, employers are permitted to provide funding for benefits that are expected to be provided in the future even though all events have not occurred that have fixed the liability for those benefits. For example, if benefits under a plan are based on the level of employees' pay during a period preceding retirement, a funding method used by the plan may require that current contributions be based on the anticipated future pay of the employees. Under these circumstances, current funding may reflect pay raises that are anticipated to be provided many years in the future.

Unanticipated investment yield.—In funding a plan, assumptions are made regarding the anticipated rate of investment earnings. Because actual experience usually differs from anticipated experience, plans periodically record experience gains (when the experience is better than anticipated) or experience losses (when the experience is worse than anticipated). These experience gains and losses are taken into account by plans, through changes in funding, over a period of 15 years. Similarly, changes in actuarial assumptions under a plan may result in increases or decreases in anticipated liabilities. Changes due to changes in actuarial assumptions are also taken into account over a 15-year period.

Effect of termination.—If a defined benefit pension plan is terminated, then no further benefits will be earned under the plan. In addition, pay raises after the date of termination are not taken into account in determining benefits. Actuarial error results because the anticipated expense of benefits expected to be earned, including benefits based on expected pay raises, will not be incurred. Similarly, actuarial error may arise because experience gains and losses as well as gains and losses from changes in actuarial assumptions may not have been fully reflected in reductions in funding levels. The reduction in liabilities because of these factors may be offset by the cost of complying with the requirement that all accrued benefits under a defined benefit pension plan must be fully vested, to the extent funded, upon plan termination.

In recent years, some terminated defined benefit pension plans have realized substantial experience gains because they have been able to meet their benefit obligations by buying annuity contracts providing a significantly higher rate of return than was assumed by the plan.

Types of terminations

Complete termination.—Present law generally prohibits an employer from diverting plan assets to its own use as any time prior to the satisfaction of the plan's liabilities with respect to employees and their beneficiaries. On termination of a plan however, after these liabilities are satisfied, remaining assets may revert to the employer. Upon termination of a qualified defined benefit pension plan, all benefits provided by the plan are required to be vested.

Split-up termination.—In some cases, reversions have been permitted after the split-up of a plan into two plans. Under this arrangement, the plan to which excess assets have been allocated is terminated and the other plan is continued. For example, a defined benefit pension plan may be divided into one plan for employees whose benefits are being paid currently and a second plan for other employees. Under present law, the allocation of assets and liabilities between the two new plans must be such that if both plans terminated immediately after the allocation, then the allocation would not cause a reduction in the benefits payable by the plans to any employee. In a split-up termination, the excess assets are allocated entirely to the plan for employees whose benefits are being paid currently. If that plan buys annuity contracts to satifisfy its obligations to provide benefits, then the excess assets can revert from that plan to the employer. The termination does not result in additional vesting because the benefits of employees covered by the terminated plan were fully vested before the transaction. After the reversion, the second plan continues in existence.

Termination-reestablishment.—In other cases, after taking a reversion from a terminated defined benefit pension plan, an employer may establish a new plan. The new plan may be another defined pension plan or it may be another type of program. Under some termination-reestablishment arrangements, the new program is a defined benefit pension plan that has the same benefit formula as the terminated plan except that benefits under the new plan are reduced by benefits provided by the terminated plan. To the extent benefits provided by the terminated plan were not previously vested, the transaction results in additional vesting.

Direct transfers.—In the past, the Internal Revenue Service took the position that if a qualified defined benefit pension plan was overfunded, on a termination basis, it could transfer excess assets directly to a qualified defined contribution plan of the employer. Because the transfer could have the effect of satisfying the employer's obligation to make a contribution to the transferee plan, the transaction can have the effect of a reversion. The Internal Revenue Service had determined that, under these circumstances, the amount transferred was not includible in the gross income of the employer and was not deductible by the employer. The Internal Revenue Service has indicated that its prior position is being reexamined.

Implementation Guidelines

In response to concern that reversions can reduce the security of benefits, procedural guidelines were developed jointly by the Department of the Treasury, the Department of Labor, and by the PBGC. The procedures, referred to as the "Implementation Guidelines for Terminations of Defined Benefit Pension Plans", or the "Implementation Guidelines", were issued by the Department of the Treasury 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 split-up termination or a termination-reestablishment transaction only if certain conditions are met.

A split-up 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 method (with the approval of the Internal Revenue Service), 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 Internal Revenue Service).

The guidelines note that split-up 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 test prohibits an employer from engaging in either of the transactions earlier than 15 years after one of them has occurred.

Tax treatment of reversions

Under present law, the level of deductions allowed to an employer for contributions to a qualified defined benefit pension plan is generally not lower than the amount the employer is required to contribute to the plan under the minimum funding standard. In addition, the investment earnings on plan assets held under a qualified defined benefit pension plan are generally exempt from income tax. Generally, benefits provided under a qualified plan are not includible in gross income until they are distributed.

Under present law, the amount of a reversion is includible in gross income of the employer. The tax treatment of a reversion is not affected by the Implementation Guidelines.

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