[JOINT COMMITTEE PRINT]

TAX REFORM PROPOSALS: PENSIONS AND DEFERRED COMPENSATION

FOR THE USE

OF THE

COMMITTEE ON WAYS AND MEANS

AND THE

COMMITTEE ON FINANCE

PREPARED BY THE STAFF

OF THE

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INTRODUCTION

This pamphlet[1] is prepared by the staff of the Joint Committee on Taxation for the House Committee on Ways and Means and Senate Committee on Finance. This pamphlet is one of a series of tax reform proposal pamphlets, and it describes and analyzes tax provisions and proposals relating to the tax treatment of pensions and deferred compensation arrangements.

The pamphlet describes present law tax provisions and the various tax reform proposals made by President Reagan ("The President's Proposals to the Congress for Fairness, Growth, and Simplicity," May 1985, referred to as the "Administration Proposal"), the 1984 Treasury Department recommendations to the President ("Tax Reform for Fairness, Simplicity, and Economic Growth," November 1984, referred to as the "1984 Treasury Report"), Congressional proposals (identified by the primary sponsors), and other related proposals.

The first part of the pamphlet is an overview of tax-favored pension and deferred compensation arrangements. The second part discusses the treatment of tax-favored savings. The third part discusses minimum standards for qualified plans. Part four discusses withdrawal of benefits under certain tax-favored pension and deferred compensation arrangements, and part five discusses limitations on the tax deferral under qualified plans.

This pamphlet does not contain a description of the rules relating to employee stock ownership plans (ESOPs). Those provisions will be included in another pamphlet to be prepared by the staff of the Joint Committee on Taxation.

[1] This pamphlet may be cited as follows: Joint Committee on Taxation, *Tax Reform Proposals: Pensions and Deferred Compensation* (JCS-33-85), August 5, 1985.

I. OVERVIEW OF TAX-FAVORED PENSION AND DEFERRED COMPENSATION ARRANGEMENTS

In general

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. If there is a transfer of property in exchange for services, the individual performing the services is required to include the value of the property in gross income when the property is not subject to a substantial risk of forfeiture. In addition, the gross income of a taxpayer generally includes noncash items that are equivalent to cash. An employer's deduction for compensation paid to employees is postponed if the employee's income inclusion is postponed.

Historically, exceptions to the doctrine of constructive receipt have been adopted by Congress 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 generally 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 otherwise be considered constructively received or equivalent to cash. Also, employers are allowed deductions (within limits) when contributions are made to these plans.

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, profit-sharing, and stock bonus 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 contri-

[2] Sec. 219(f) of the Revenue Act of 1921.
[3] Sec. 219(f), sec. 23(p) of the Revenue Act of 1926.

butions and benefits. That Act also provided for insurance of some benefits under defined benefit pension 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. This employment tax exclusion does not apply to elective deferrals under a qualified cash or deferred arrangement. Present law also provides relief from the effect of graduated tax rates by providing special income averaging rules for certain lump sum distributions and special treatment for net unrealized appreciation in employer securities.

Sources of income for persons age 65 and over

A better understanding of the potential impact of the tax incentives provided to various pension and deferred compensation arrangements can be acquired by comparing the magnitudes and distributional characteristics of the primary sources of income among persons of retirement age. Major sources of income for persons age 65 and over include wages and salaries, pensions, social security benefits, interest and dividends, and capital gains. Table 1 provides both the amount and number of returns for each of these income sources for taxpayers (expanded to include filing and nonfiling units) aged 65 and over at 1983 levels, distributed by adjusted gross income class.

As indicated by the table, social security benefits plus distributions from pension plans (pensions paid by private plans plus pensions paid to Federal, State and local government employees, and military personnel) comprise less than half of all income going to taxpayers of this age group.

Social security benefits represent the largest single source of income to taxpayers age 65 and over. However, while over 90 percent of these taxpayers received at least some social security benefits in 1983, those benefits represented only 29 percent of total income ($113 billion of $387 billion) from all sources. An amount almost as large, $103 billion, came from interest and dividend income.

Of the $387 billion in total income shown in Table 1, a relatively small share, $70 billion or 18 percent, can be attributed to distributions from pension plans of all types—private and public (including military). Slightly over half (52 percent) of the 19.6 million returns included at least some pension income.

The average amount obtained from all income sources was approximately $19,800 per return for 1983. However, of the 19.6 million returns for which information is provided, two-thirds or 13.1 million had income from all sources which totalled less than $10,000.

TABLE 1.—SOURCES OF INCOME FOR RETURNS OF TAXPAYERS AGE 65 OR OVER

[Returns in thousands; amounts in millions of dollars]

Adjusted gross income (thousands)	Wages and salaries		Pension income [1]		Social Security [2]		Interest and dividends		Capital gains		Other income		Total	
	Returns	Amount	Returns	Amount	Returns	Amount	Returns	Amount	Returns	Amount	Returns	Amount	Returns	Amount
Less than $10	1,462	6,294	6,270	36,983	12,352	73,360	4,027	16,321	425	1,822	1,582	−1,051	13,076	133,729
$10–$20	1,106	9,610	2,290	17,313	3,012	22,033	3,090	21,068	531	1,881	840	1,661	3,379	73,566
$20–$30	575	8,929	700	7,197	1,065	7,793	1,320	14,640	367	2,235	473	1,607	1,360	42,401
$30–$40	249	4,716	294	2,866	435	2,993	544	8,296	229	1,822	258	1,071	563	21,764
$40–$50	132	2,916	222	2,101	338	2,649	435	9,252	197	1,697	179	1,082	440	19,697
$50–$75	207	5,417	172	1,505	331	2,464	408	10,976	197	3,624	212	2,335	420	26,321
$75–$100	66	2,691	65	786	103	810	141	5,504	73	2,132	90	1,134	141	13,057
$100–$200	80	4,650	66	1,241	101	794	149	8,452	88	4,305	107	3,063	149	22,505
$200 and over	28	4,341	25	370	32	259	47	8,592	32	15,100	39	5,774	47	34,436
Total	3,906	49,564	10,103	70,364	17,768	113,154	10,162	103,100	2,140	34,616	3,780	16,677	19,574	387,475

[1] Includes private and public pensions plus military retirement benefits.
[2] Includes social security and railroad retirement benefits.

Note.—Estimated at 1983 income levels for taxable and nontaxable returns where the principal taxpayer is age 65 or over. Also included are estimated data for nonfilers. Detail may not add totals due to rounding.

Source: Estimates prepared by the staff of the Joint Committee on Taxation using information from the IRS Statistics of Income and the 1984 Current Population Survey (reported data at 1983 levels).

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.

A qualified pension plan may be either a defined benefit pension plan or a money purchase pension plan. Under a 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 pension plan may also 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 guaranteed (within limits) by the Pension Benefit Guaranty Corporation (a Federal corporation within the Department of Labor).

Under a money purchase pension plan, the amount of employer contributions allocated to the account of an employee must be fixed or determinable. A money purchase pension plan is a type of defined contribution plan; therefore, the amount an employee is entitled to receive is based solely on the balance in the employee's account (adjusted for earnings). 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 are also types of defined contribution plans. Under a profit-sharing plan, employer contributions are provided out of current or accumulated profits of the employer. 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 profit-sharing or stock bonus plan, benefits can be distributed to an employee who has not separated from service.

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 (IRAs), 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 do not include benefits in gross income until the benefits are distributed even though the plan is 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. The employer is entitled to a current deduction (within limits) for contributions to a qualified plan even though an employee's income inclusion is deferred.

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 to ensure the solvency of pension plans.

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 2, below, shows the distribution of coverage under pension plans by compensation levels for 1983.

Table 2.—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–$10,000	16,961	4,908	28.9
$10,000–$20,000	29,926	17,405	58.2
$20,000–$30,000	16,103	12,216	75.9
$30,000–$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 from the plans. 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. Approximately 3 million persons are presently covered by these annuities.

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. Over $3 billion in contributions were made to tax-sheltered annuities in 1983.

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

Unlike 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.

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 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 exceeded $32 billion. (See Table 3.) 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 percentage of aggregate contributions for all classes.

Table 3.—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]	Returns: Number returns	Returns: As a % of eligible returns	Returns: Percent distribution	Amount of payment: Total amount	Amount of payment: Percent distribution	Amount of payment: Average amount
(Thousands of dollars)	(Thousands)	(Thousands)	(Percent)	(Percent)	(Millions of dollars)	(Percent)	(Dollars)
Less than 10	27,992	645	2.30	4.70	1,024	3.17	1,588
10–20	21,297	2,010	9.44	14.65	3,648	11.28	1,815
20–30	14,781	2,945	19.92	21.46	6,028	18.63	2,047
30–40	9,814	2,860	29.14	20.84	6,804	21.03	2,379
40–50	4,778	2,140	44.79	15.60	5,638	17.43	2,635
50–100	3,979	2,558	64.29	18.64	7,536	23.30	2,946
100–200	523	431	82.41	3.14	1,292	3.99	2,998
200 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: Internal Revenue Service, *Statistics of Income Advanced Data,* 1983.

Unfunded governmental plans

In general, individuals are currently taxed not only on compensation actually received, but also on compensation constructively received during the taxable year. The Internal Revenue Service has taken the position that an individual is treated as having constructively received compensation during the current taxable year if the compensation would have been payable during the current taxable year but for the individual's election to defer receipt of the compensation to a later taxable year (Prop. Reg. sec. 1.61-16). An exception to this special rule applies to certain compensation deferred under a plan of a taxable employer.

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 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. The restrictions are designed to restrict nonretirement use of the deferred amounts.

Effect of further legislation

It should be noted that many of the proposals made with respect to tax-favored pension and deferred compensation arrangements are interrelated with other proposals. Consequently, some of the proposals could require modification if they are adopted separately. Further, if some of the proposals are adopted, conforming changes in the Code and ERISA may be required. Finally, if some of the proposals are enacted, other proposals may be unnecessary.

Significant pension changes were recently made by the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA), and the Retirement Equity Act of 1984 (REA). Plan sponsors are currently attempting to comply with those changes. Compliance with changes made by these Acts involves strategic analysis of the impact of the legislation, possible plan redesign, document revisions, employee communication, and, usually, submission of a request for an IRS determination letter with respect to the qualified status of the plan, as amended. Some note that the new rules impose new costs and administrative burdens on plans. They argue that it is inappropriate at this time to initiate a new round of significant legislative changes that would necessitate another round of compliance burdens because some employers may conclude that the costs and burdens of compliance with further legislative changes will outweigh the benefits of maintaining a qualified plan. They argue, therefore, that additional legislation at this time placing new burdens on employers may cause many of those employers to terminate their plans so that employees will be deprived of retirement benefits that Congress seeks to enhance.

Others believe that some employers who terminate their plans in response to legislative changes maintain plans that generally fail to deliver adequate benefits to rank-and-file employees and their beneficiaries. They suggest that these plan terminations may actually lead to a more appropriate use of the tax incentives associated with tax-favored pension and deferred compensation arrangements. Those who support further legislative change in the rules for tax-favored pension and deferred compensation arrangements point out that, while past legislative changes were received with similar predictions of massive plan terminations, the total number of plans maintained by employers has continued to grow.

II. TREATMENT OF TAX-FAVORED SAVINGS

A. Individual Retirement Arrangements (IRAs)

Present Law and Background

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.

Many plan participants argued that additional incentives for personal retirement savings were necessary for all individuals because even those who were active participants in employer plans often received inadequate retirement benefits due to social security integration and deferred vesting. Accordingly, 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. The deduction limit was increased, from the lesser of 25 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 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 70-1/2; 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 age 59½, death, or disability of the owner of the IRA are subject to a 10-percent additional income tax (sec. 408(f)). (See, also, the discussion relating to Withdrawal of Benefits under Qualified Plans, in Part IV., below.)

Administration Proposal

The Administration proposal provides that, for purposes of calculating an individual's IRA deduction limit for a year, the earned income of the individual's spouse could be considered if the couple filed a joint return. Thus, deductible IRA contributions of up to $2,000 per year to each individual's IRA would be permitted for a couple filing a joint return provided their combined earned income was at least $4,000. This spousal IRA provision would apply to taxable years beginning after December 31, 1985.

In addition, the Administration proposal generally increases the additional income tax on withdrawals prior to age 59½, death, or disability. (For a detailed discussion of this proposal, see the discussion relating to Withdrawal of Benefits under Qualified Plans in Part IV., below.)

Other Proposals

1984 Treasury Report

The 1984 Treasury report proposed to increase the annual IRA deduction limit from $2,000 to $2,500 and would have permitted the earned income of an individual's spouse to be taken into account in calculating the limit. Thus, under the proposal, deductible IRA contributions of up to $2,500 to each individual's IRA would have been permitted for a couple filing a joint return provided their earned income was at least $5,000.

H.R. 1377 (Stark)

H.R. 1377 would reduce the dollar limitation on annual IRA contributions by 20 percent in the case of any "revenue enhancement year." A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989.

Thus, for any such year, the dollar limit applicable to an IRA would be reduced from $2,000 to $1,600, and the aggregate dollar limit applicable to spousal IRAs would be reduced from $2,250 to $1,800.

S. 556 (Chafee)

S. 556 would reduce the dollar limitation on annual IRA contributions by 15 percent in the case of any revenue enhancement year. A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989.

Thus, the dollar limit applicable to an IRA would be reduced from $2,000 to $1,700, and the aggregate dollar limit applicable to spousal IRAs would be reduced from $2,250 to $1,912.50.

S. 411 and H.R. 373 (Roth-Moore)

Under S. 411 and H.R. 373, an individual would be allowed a deduction (within limits) for contributions paid to a super savings account. The deduction limit for any taxable year would be the excess of the applicable limit over deductible IRA contributions for the year. The applicable limit for 1986 would be $16,000 for a married couple filing a joint return and $8,000 for all other taxpayers. These limits would be increased by $1,000 per year not to exceed $20,000 and $10,000, respectively, for taxable years beginning in 1990 and thereafter.

In general, the proposal provides that the tax treatment of amounts contributed to a super savings account would be determined in a manner similar to the tax treatment of IRAs. Thus, amounts withdrawn from a super savings account would be includible in gross income for the taxable year in which the amounts are withdrawn. However, under the proposal, there would be no restrictions on withdrawals from super savings accounts, and the 10-percent additional income tax would not apply to distributions prior to age 59-1/2, death, or disability.

Survivor benefits for IRAs

Some have proposed that the survivor benefit requirements (sec. 401(a)(11)) applicable to qualified plans should be extended to apply to IRAs.

Analysis

It has been suggested that the rationale for granting favorable tax treatment to contributions to IRAs generally centers on three issues: (1) whether IRAs encourage individuals to save for their own retirement and, therefore, contribute to increased retirement income security; (2) whether IRA contributions create additional savings that contribute to the formation of investment capital needed for economic growth; and (3) whether the withdrawal restrictions on IRAs, which are designed to ensure that IRA accumulations are used to provide retirement income, deter individuals from making IRA contributions.

Retirement income security

The issue of whether IRAs encourage individuals to save for their own retirement and, thereby, ensure greater retirement income security in the United States has generated much debate in recent years. In 1981, when all individuals became eligible to make deductible IRA contributions, Congress noted its concern that a large number of the country's workers, including many covered by employer-sponsored retirement plans, face the prospect of retiring without the resources needed to provide adequate retirement income levels.

Utilization

The data on IRA contributions for years after 1981 show that the greatest participation is among middle- and upper-income taxpayers. For example, for 1983, over 66 percent of total IRA contributions were made by taxpayers with adjusted gross income over $30,000. In addition, the percentage of total spousal IRA contributions made by this group was 76 percent.

Some argue that these statistics demonstrate that the present-law tax incentives for IRA contributions will lead to greater retirement income savings only for taxpayers for whom private and public pensions and personal saving are more likely to be adequate during retirement. This group, it is argued, has a propensity to save regardless of the tax incentives, and the incentives merely cause a shifting of part of the cost of retirement saving to the Federal Government. Accordingly, some would propose that the tax incentives for making IRA contributions should be reduced or eliminated. They also argue that the rules requiring qualified plans to provide nondiscriminatory benefits are consistent with the goal of assuring that tax incentives are provided only if lower income individuals also participate. If this were not the goal, they point out, the rules for qualified plans could be repealed and all individuals could be permitted a much larger annual IRA deduction limit.

On the other hand, some assert that IRAs represent a more efficient tax incentive for retirement savings because an individual need not rely either on the employer's decision to maintain a qualified plan or on the level of benefits or contributions provided under a plan maintained by an employer.

Proponents of IRAs also point out that IRAs are utilized by a significant percentage of middle-income taxpayers. They point out that approximately 10.4 million taxpayers whose adjusted gross incomes were less than $50,000 made deductible IRA contributions for 1983. They suggest that this utilization rate confirms that IRAs are not merely a tax-favored vehicle for upper-income taxpayers. Further, it is argued that many taxpayers will enjoy higher incomes as they approach retirement age and that these taxpayers will be able to benefit from IRAs. It is also suggested that all taxpayers indirectly benefit from the additional capital provided through IRA savings.

Tax-credit IRAs

Alternatively, some have proposed that the incentive to make IRA contributions should be greater for lower-income taxpayers, who are less likely to save. Under present law, the value of a deduction for IRA contributions increases with a taxpayer's marginal tax rate with the greatest benefit provided to taxpayers who are taxed at the highest marginal rate. For example, an IRA contribution of $2,000 saves $1,000 of tax for an individual taxed at a 50-percent marginal rate, whereas the tax saving is $440 for an individual taxed at a 22-percent marginal rate.

Those who support providing a tax incentive that is greater for lower-income taxpayers have proposed converting the IRA deduction to a credit whose rate does not exceed the lowest marginal tax rate, thereby providing a tax incentive that is greatest for taxpayers with the lowest income. For example, under the Administration's proposed rate structure, a 15-percent credit could be provided for IRA contributions. Some assert that this credit would also prevent the pre-retirement arbitrage opportunity that exists under present law under which an individual's marginal tax rate is higher when a deductible IRA contribution is made than the marginal tax rate that applies when the individual begins withdrawing the IRA amounts and includes them in income.

On the other hand, some argue that an IRA credit creates additional complexity that is unnecessary if the top marginal tax rate is significantly reduced. Under the Administration's proposed rate structure, the maximum tax savings due to a $2,000 IRA deduction would be $700 (at a 35-percent marginal tax rate), and the lowest tax savings would be $300 (at a 15-percent marginal tax rate). This group argues that the IRA deduction should be retained and that any concerns about tax benefits to lower-income taxpayer should be addressed directly through personal exemptions and the rate structure. They point out that tax incentives, whether as a deduction or credit, will not compel some individuals, who lack discretionary income, to save for retirement.

Others point out that, although the tax benefit to higher income taxpayers is reduced if tax rates are lowered, an IRA deduction continues to provide a disproportionate benefit to such taxpayers. They suggest that a tax credit is preferable, despite the complexity.

Finally, supporters of IRA deductions argue that the incentive for individual retirement savings can remove additional pressure from the social security system. They argue that IRAs, through penalties on premature withdrawals and limits on deductions, are more likely than many tax incentives to accomplish their intended goals.

Increased savings

Data presently available generally do not demonstrate whether IRA contributions represent new savings that lead to greater capital formation. Some suggest that the appropriate question is whether IRAs stimulate new savings other than the tax savings provided by the IRA provisions. Although little empirical data are available to answer this question, many economists have attempted to address it on a theoretical basis.

In one such study,[4] it was suggested that the historical evidence of IRA utilization, which is weighted to middle- and upper-income levels, supports a theory that IRA contributions represent a shifting of savings from nontax-favored vehicles to tax-favored vehicles. The authors of that study pointed out that the group for whom IRA contributions are the highest are likely to have significant existing savings from which they can fund their IRA contributions. Under this theory, some argue that the revenue loss attributable to deductible IRA contributions is not justified as a means of infusing additional investment capital into the economy.

On the other hand, another study[5] that examined the incentive to save through IRA contributions concluded that there is a positive correlation between the IRA tax incentive and the propensity to save. This study also demonstrated that the correlation increases as marginal tax rates increase. However, the authors of the second study pointed out that data are not available to confirm this theory of the impact of IRAs on net saving.

Some contend that the issue of whether or not IRA contributions represent a source of new capital is irrelevant. Those who support this view argue that evaluation of the tax benefits for IRA contributions should depend on whether IRAs produce greater retirement income without regard to any possible effect on capital for-

[4] DeMagistris, Robin, and Carl Palash, "Impact of IRAs on Saving," *Federal Reserve Bank of New York Quarterly Review* Vol. 7, (Winter 1982-83), pp. 24-32.

[5] Hubbard, R. Glenn, "Do IRAs and Keoghs Increase Saving?" *National Tax Journal*, Vol. 37, pp. 43-54.

mation and that other tax incentives should be used, if necessary, to encourage the creation of new capital. In addition, they suggest that the appropriate question is not whether IRAs increase total savings but whether the existence of tax incentives for IRAs stabilize savings by inducing long-term savings.

On the other hand, some have suggested that the impact of IRA deductions on the formation of new capital is the most important function of tax incentives for IRAs. Included in this group are those who favor an exemption from tax for all savings (e.g., a consumption or "consumed income" tax). For example, the Roth-Moore bill would exempt from tax up to $20,000 a year for contributions to a super savings account. Some would support a proposal exempting all saved income without limit.

Withdrawal restrictions

The issue of when individuals should have unrestricted access to tax-favored retirement funds and when distribution from those funds should be required presents the fundamental tension created by the overlapping of retirement policy with Federal tax policy. Some suggest that retirement income security may be best achieved by barring distributions of retirement savings prior to retirement age and by encouraging the use of retirement saving only when needed after retirement. Some argue, in addition, that Federal income tax policy should be applied to prevent excessive deferral and arbitrage of retirement savings and to ensure that such savings are not used to transfer wealth to another generation. They point out that the deferral of tax is minimized if savings are withdrawn before retirement. (For additional discussion of this issue, see, also, the discussion relating to Withdrawal of Benefits under Qualified Plans, Part IV., below.)

In the context of favorable tax treatment for IRAs, some have suggested that restrictions on withdrawals from IRAs are unnecessary and inappropriate. Proponents of this approach argue that many individuals, particularly lower-paid individuals, are more likely to engage in long-term saving if they know that they will have access to their funds for emergencies. It is suggested that IRA utilization would be much greater at lower-income levels if withdrawal penalties were removed. It is argued that this, in turn, would also tend to keep more funds in IRAs and would ensure greater retirement income security.[6]

Others argue that withdrawal penalties are necessary to guarantee that tax-favored retirement funds are used for retirement purposes. Under this view, favorable tax treatment for IRAs is exclusively designed to encourage retirement savings, and any increase in investment capital is merely a coincidental benefit. Supporters of this view claim that eliminating withdrawal restrictions of IRAs would not lead to greater retirement income security, because even if savings increased among lower-income taxpayers, these taxpayers would be likely to withdraw the funds after a short period of time to meet current consumption needs. Those who oppose elimi-

[6] A 1985 survey of individuals conducted by the Investment Company Institute shows that many people believe they would be more likely to make IRA contributions if the withdrawal restrictions were eliminated.

nating withdrawal restrictions argue that, without the restrictions, IRAs would be viewed as tax-favored savings accounts.

The opponents argue that government support of other social goals, such as higher education, should also be addressed separately so as not to provide a mechanism to undermine the retirement security goal of qualified plans. They argue that the fact that retirement is so distant in time and of such uncertain duration makes it a unique problem, which should be treated separately under the tax laws.

Level of sanction

Those who support the Administration proposal to increase the present 10-percent additional income tax on early withdrawals to 20 percent, except in the case of withdrawals for certain purposes, (e.g., the purchase of a first principal residence), believe that the present-law sanction is not sufficiently high to discourage early withdrawals. They point out that, for taxpayers whose income is taxed at high marginal rates, the sanction may be neutralized by the tax-free compounding of interest after a period of five to six years. This, they argue, is an insufficient deterrent to the use of retirement funds for nonretirement purposes.

The following table (Table 4) shows the number of years of tax-free growth needed on an IRA contribution to offset a penalty for early withdrawals. For example, in the case of a taxpayer in a 35-percent tax bracket, who earns 12 percent interest on IRA contributions, the benefit of tax-free growth offsets a 10-percent additional income tax in 4.4 years, whereas a 20-percent tax is not offset until the contributions have been held for 9.6 years.

Table 4.—Breakeven Period (in Years) for Tax-Deferred Savings Under Various Tax, Earnings, and Penalty Assumptions

Earnings per year	Marginal tax rate					
	25%		35%		50%	
	Penalty		Penalty		Penalty	
	10%	20%	10%	20%	10%	20%
8%	7.7	16.6	6.4	14.0	5.9	13.5
10%	6.2	13.5	5.1	11.4	4.8	11.0
12%	5.3	11.4	4.4	9.6	4.1	9.3

On the other hand, some believe that a higher sanction would discourage retirement savings by most taxpayers and would be particularly troublesome to workers who expect to retire before age 59-1/2. They believe that the sanction should not be set at a rate that discourages early withdrawals by taxpayers who are subject to the highest marginal tax rates, because such a sanction would be excessive for taxpayers whose income is taxed in lower brackets. Some argue that this regressivity of the sanction is inappropriate. Similarly, they point out that the general reduction in tax rates proposed by the Administration makes the effect of increasing the additional income tax from 10 to 20 percent more significant.

An alternative to a flat additional income tax that would deal with the problem of regressivity would be to impose a tax that varies depending upon the marginal tax rate of the taxpayer. For example, the tax could be set at a percentage of the marginal tax rate of the taxpayer. Some argue that such a proportionate tax, although more fair, would add complexity to the income tax system. Another possible alternative would be to retain the present-law level of the additional income tax (i.e., 10 percent) so that the effect of regressivity is reduced.

A third alternative to a flat additional income tax would be to impose a tax based upon a sliding scale that takes into account the length of the deferral, the actual yield, or some combination of similar factors. For example, some argue that it may be appropriate to increase the tax as the ratio of the earnings on an account to the total account balance increases. Some argue that this approach would assess the additional income tax based on the level of tax-deferred earnings and, therefore, would more accurately recapture a portion of the tax benefit.

Finally, those opposed to increasing the additional income tax on premature withdrawals and the extension of the tax to all participants in all tax-favored retirement arrangements point out that the sanction is more onerous at low interest rates. They argue that, if the sanction is increased, it will adversely affect people who cannot accumulate sufficient retirement savings to obtain high investment yields.

Survivor benefits for IRAs

Under present law, a qualified plan is required to provide automatic survivor benefits (1) in the case of a participant who retires under the plan, in the form of a qualified joint and survivor annuity, and (2) in the case of a vested participant who dies before the annuity starting date (the first period for which an amount is received as an annuity under the plan) and who has a surviving spouse, in the form of a qualified preretirement survivor annuity. A participant is given the opportunity to waive the qualified joint and survivor annuity and qualified preretirement survivor annuity during an applicable election period. The consent of a participant's spouse is required for an election to decline the qualified joint and survivor annuity and the qualified preretirement survivor annuity.

Some believe that the survivor benefit requirements applicable to qualified plans should be extended to IRAs. They suggest that these requirements are necessary to ensure that the spouse generally will be favored over other beneficiaries because it is necessary to recognize the status of marriage as an economic partnership.

Others assert that the proposal to extend survivor benefit requirements to IRAs should not be adopted unless profit-sharing and stock bonus plans are also required to meet the survivor benefit requirements.

It is also argued that these survivor benefit provisions are necessary so that simplified employee pensions (SEPs) are subject to the survivor benefit provisions. Some suggest that, unless SEPs are required to provide automatic survivor benefits to surviving spouses, employers could avoid the survivor benefit provisions while still providing significant benefits to employees.

Opponents of this approach argue that the spousal IRA rules are adequate to deal with the problem of benefits for a surviving spouse. They also suggest that imposing survivor benefit requirements on IRAs would introduce significant complexity and administrative burdens for IRA sponsors.

B. Qualified Cash or Deferred Arrangements

Present Law and Background

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 tax 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 through 1978, when Congress enacted special rules relating to qualified cash or deferred arrangements (also referred to as CODAs or sec. 401(k) plans). 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 the compensation had been received.

If a tax-qualified profit-sharing or stock bonus plan (or certain pre-ERISA money purchase pension plans) meets certain requirements described below (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 1/3 of all employees. These nondiscrimination tests provide that the special treatment of elective deferrals is not available unless the cash or deferred arrangement does not disproportionately benefit highly paid employees.

The tests are based on the relationship of the actual 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 actual 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 three percentage points. If the three 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, 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 (Table 5) shows the maximum deferral by the highly paid employees given different deferrals by all other eligible participants.

Table 5.—Present Law Average Deferral Limits Applicable to Cash or Deferred Arrangements

[Percent of compensation]

Deferrals by Lower 2/3 Employees	Maximum Deferral for Top 1/3 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, retirement, or the occurrence of a hardship. What constitutes the occurrence of a hardship under present law has not been defined.

Limit on elective deferrals

Elective deferrals under a qualified cash or deferred arrangement are subject to the overall 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 nondeferred compensation.

Administration Proposal

Overview

The Administration proposal relating to qualified cash or deferred arrangements would (1) modify the special nondiscrimination rules applicable to cash or deferred arrangements, (2) reduce the dollar limit on the annual amount of elective deferrals, and (3) modify the coverage requirements.

Limit on elective deferrals

Under the Administration's proposal, the maximum amount that an employee could elect to defer for any year would be limited to $8,000. Consequently, although total annual additions (including employee elective deferrals) would be limited to the lesser of 25 percent of compensation or $30,000, elective deferrals could not exceed $8,000. In addition, the $8,000 limit would be coordinated with the annual deduction limit for IRA contributions. Under the proposal, an employee's elective deferrals under a qualified cash or deferred arrangement for a year would reduce, dollar for dollar, the employee's IRA deduction limit.

Nondiscrimination requirements

The Administration's proposal would modify the special nondiscrimination tests applicable to qualified cash or deferred arrangements by redefining the group of highly compensated employees and by modifying the special percentage tests.

Under the proposal, an employee would be treated as highly compensated with respect to a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee (1) owns an interest of at least one percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) earns at least $20,000 in compensation and is among (a) the top 10 percent of employees by compensation, or (b) the top three employees by compensation; or (4) a family member of another highly compensated employee.

In addition, the Administration proposal would alter the special nondiscrimination tests so that the deferrals under a cash or deferred arrangement by any highly compensated employee may not exceed either (1) 125 percent of the average deferrals of all nonhighly compensated employees or (2) the lesser of 200 percent of the average deferrals of all nonhighly compensated employees or the average deferrals for all nonhighly compensated employees plus two percentage points.

Finally, if the special nondiscrimination rules are not satisfied for any year, the proposal would provide that the excess elective contributions by the highly compensated employees would be treated as nondeductible employer contributions. These excess contributions would be subject to the excise tax on contributions in excess of the deduction limits. (See discussion of Employer Deductions in Part V. B., below.) In addition, excess elective deferrals would be required to be distributed by the end of the plan year following the plan year to which the deferral relates to avoid disqualification of the plan.

Nondiscriminatory coverage

Under the proposal, the percentage of highly compensated employees eligible to make elective deferrals under a qualified cash or deferred arrangement would be computed. That percentage would be compared to the corresponding percentage of other employees who participate in the plan. The percentage for highly compensated employees generally would not be permitted to exceed 125 percent of the percentage calculated for other employees.

Certain employees could be disregarded in applying the coverage test. Under the proposal, the group of employees with less than one year of service and the group of employees who have not attained age 21 could be disregarded for purposes of the special coverage test as long as the plan did not cover any employees within the specified group. In addition, employees not covered by the plan who are covered under a collective bargaining agreement and certain nonresident aliens would be required to be disregarded under the proposal.

For example, an employer who wished to provide benefits for all highly compensated employees would be required to provide benefits to at least 80 percent of the nonhighly compensated employees. (This result occurs because 100 percent (the ratio of highly compensated employees benefiting under the plan to all highly compensated employees) does not exceed 80 percent (the corresponding ratio calculated for nonhighly compensated employees) by more than 125 percent.)

Other restrictions

The proposal would impose several additional restrictions on cash or deferred arrangements. First, no withdrawals would be permitted under a qualified cash or deferred arrangement prior to death, disability, separation from service, or plan termination. Thus, hardship withdrawals would not be permitted and distributions would not be allowed merely because an employee has attained age 59½.

Under the proposal, an employer could not condition, either directly or indirectly (other than through matching contributions), contributions and benefits upon an employee's elective deferrals. For example, an employer could not require an employee to make contributions under a cash or deferred arrangement as a condition of participating in a pension plan. Similarly, elective deferrals under a qualified cash or deferred arrangement could not be used to ensure that another plan, when combined with the cash or deferred arrangement, satisfies the usual nondiscrimination requirements (sec. 401(a)(4)). In addition, a floor offset defined benefit pension plan could not provide for offsets attributable to elective deferrals.

Finally, the proposal provides that qualified cash or deferred arrangements would not be available to employees of tax-exempt organizations or governmental entities.

Other Proposals

1984 Treasury Report

The 1984 Treasury report would have repealed the special provisions relating to qualified cash or deferred arrangements. Under the proposal, amounts an employee elected to defer would be includible in the employee's gross income for the year deferred and would be treated as either voluntary or mandatory employee contributions to a qualified plan.

S. 409 and H.R. 800 (Bradley-Gephardt)

Under S. 409 and H.R. 800, the annual dollar limit on contributions to a defined contribution plan would be reduced from $30,000 to $20,000. Thus, the dollar limit on employer contributions (including elective deferrals under a qualified cash or deferred arrangement) would also be reduced from $30,000 to $20,000.

H.R. 1377 (Stark)

H.R. 1377 would reduce the dollar limit on contributions to a defined contribution plan (including elective deferrals under a qualified cash or deferred arrangement) by 20 percent in the case of any revenue enhancement year. A revenue enhancement year means any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989. Thus, for any such year, the dollar limit would be reduced from $30,000 to $24,000.

S. 556 (Chafee)

S. 556 would reduce the dollar limit on contributions to a defined contribution plan (including elective deferrals under a qualified cash or deferred arrangement) by 15 percent in the case of any revenue enhancement year. A revenue enhancement year means any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989. Thus, for any such year, the dollar limit would be reduced from $30,000 to $25,000.

Special nondiscrimination tests

Some have proposed that the special nondiscrimination tests for qualified cash or deferred arrangements should be modified so that no differential would be permitted between the rate of contribution by each highly compensated employee and the rate of contributions by rank-and-file employees. Under such a proposal, the rate of deferrals by highly compensated employees could be no more than 100 percent of the rate of deferrals by all other employees. Alternatively, some have proposed that no differential should be permitted if the employer maintains another qualified plan that is integrated with social security.

Analysis

Under the usual principles of the Federal income tax system, individuals are taxed on their income as they earn it. Historically, employer contributions to tax-favored retirement arrangements on behalf of employees were not treated as current income. On the other hand, the amounts of current income that an employee elected to save (including amounts saved on a tax-favored basis) have generally been includible in gross income for the year in which earned.

In 1974, however, Congress enacted an exception to the general principle that income is taxed as it is earned by providing that certain retirement savings contributed to an IRA could be accumulated on a tax-deferred basis. At that time, the Congress imposed a $1,500 limit on annual IRA contributions and restricted the class of taxpayers eligible to make IRA contributions to those who were not active participants in a qualified plan or a governmental plan. This $1,500 limit has subsequently been raised to $2,000, and the class of eligible taxpayers has been expanded.

In 1978, when employees who were active participants in employer plans could not make deductible IRA contributions, Congress enacted the rules relating to qualified cash or deferred arrangements. Employee deferrals under a qualified cash or deferred arrangement are treated as employer contributions and subject to the general limits on annual additions to a defined contribution plan.

Some of the issues that have been raised with respect to the favorable tax treatment of employee deferrals under a qualified cash or deferred arrangement are (1) whether the limit on elective deferrals should be higher than that which is provided for deductible IRA contributions, (2) whether it is appropriate to coordinate the limits on elective deferrals under qualified cash or deferred arrangements with the limits on deductible IRA contributions, (3) whether the special nondiscrimination tests applicable to qualified cash or deferred arrangements are sufficient to encourage retirement savings by lower paid employees while preventing the plans from becoming primarily a tax-favored arrangement for highly compensated employees, and (4) whether it is appropriate to provide separate restrictions on withdrawals of elective deferrals under qualified cash or deferred arrangements.

Limit on elective deferrals

Some have argued that it is appropriate to reduce the limit on elective deferrals under a qualified cash or deferred arrangement to provide equitable treatment of similarly situated taxpayers. This group points out that present law provides greater benefits to those taxpayers whose employers offer qualified cash or deferred arrangements than are provided for other employees. They argue that employees should not be treated differently merely because some are covered by plans under which they may elect to defer their own money. Proponents of this view contend that horizontal equity requires that similarly situated taxpayers should be treated alike under the tax law. They also point out that permitting any elective deferrals will tend to result in inequitable treatment of part-time and seasonal employees, who are often excluded from a cash or deferred arrangement and, therefore, have access only to IRAs.

Those who support the Administration proposal believe that it takes a step in the direction of greater equity because it would reduce the permitted level of elective deferrals available to employees under cash or deferred arrangements and would coordinate that limit with the limit on deductible IRA contributions. This group points out that there may be no substantial difference between elective deferrals and IRA contributions because both permit an individual to decide annually whether or not income tax will be currently imposed on a portion of the employee's income. They note that the Administration proposal, which offsets the IRA deduction limit dollar for dollar by elective deferrals, has the effect of permitting IRA deductions only for those who do not contribute $2,000 to a cash or deferred arrangement. Some suggest that this result is appropriate because it avoids the inequity of the pre-ERTA IRA rules under which an individual, whose employer made a de minimis contribution to a qualified plan on the employee's behalf, was prohibited from making IRA contributions whether or not vested in the contribution.

Others point out that the Administration proposal does not fully implement the goal of equity among similarly situated taxpayers because the limit on elective deferrals under a cash or deferred arrangement would remain higher than the limit on deductible IRA contributions. Consequently, an employee whose employer did not maintain a cash or deferred arrangement would be limited to a $2,000 annual IRA contribution, while an employee whose employer did maintain a cash or deferred arrangement could reduce his or her salary by up to $8,000 a year. Some suggest that equity can be best achieved by creating an overall cap that applies both to annual elective deferrals and deductible IRA contributions.

On the other hand, it has been argued that it is appropriate to provide a higher limit on elective deferrals under a qualified cash or deferred arrangement than is provided for deductible IRA contributions. Those who support this view point out that special nondiscrimination rules apply to guarantee that the cash or deferred arrangement will not be used primarily to benefit highly compensated employees and suggest that this is consistent with the usual nondiscrimination rules applicable to qualified plans under which a plan is not permitted to discriminate in favor of employees who are officers, shareholders, or highly compensated. They also argue that statistics show that the utilization of IRAs is more heavily weighted to high income taxpayers than the utilization of cash or deferred arrangements.

Coordination with IRAs

Some believe that, if a higher level of elective deferrals is considered to be appropriate for employees under an employer-sponsored plan, the limits for employer plans and IRAs should not be linked. They are concerned that the rules for coordination of the limits may cause complexity and discourage savings.

The amount of complexity created by coordination of the limits depends, in part, on whether the elective deferrals or the IRA contributions are affected when the limit is exceeded. For example, if an employee makes a $2,000 IRA contribution and an $8,000 elective deferral, either the IRA contribution or $2,000 of the elective deferral is excessive. If $2,000 of the elective deferral is treated as excessive, employers will be forced to secure IRA contribution information from all employees who participate in a cash or deferred arrangement. If, however, the IRA is treated as excessive, only the employee is required to monitor levels of contributions to qualified cash or deferred arrangements and IRAs.

Those who support coordination of the limits believe that the Administration proposal will not cause administrative difficulties for plans and for the Internal Revenue Service because it would reduce the IRA deduction limit by the amount of elective deferrals under the cash or deferred arrangement. It has been suggested that, under this approach, the coordination would be done by the employees rather than by the plans.

An additional issue relating to the coordination of limits is whether the $8,000 limit should be applied as an overall limit when an employee participates in a cash or deferred arrangement of more than one employer. Some suggest that it would be extremely difficult for an employer to monitor whether an employee participates in a cash or deferred arrangement with another employer. Others argue that it is inequitable to provide a higher limit on deferrals merely because an individual participates in more than one cash or deferred arrangement with different employers and that there is little complexity if the coordination is performed at the individual level, rather than the employer level.

Special nondiscrimination tests

Individual testing

Proponents of the Administration proposal to reduce the amount that any highly compensated employee can defer in excess of the amounts that the other employees defer argue that present law permits qualified cash or deferred arrangements to be used substantially to benefit highly compensated employees. They argue that the use of average deferrals by highly compensated employees effectively permits some highly compensated employees to have much higher deferrals (as a percentage of pay) than the rank-and-file employees.

Some suggest that it is not appropriate to provide tax subsidies to a cash or deferred arrangement unless the level of participation by the rank-and-file employees is near the level of participation of the highly compensated employees. Otherwise, they assert, the qualified cash or deferred arrangement becomes little more than a super IRA for highly compensated employees.

Assume, for example, that a group of highly compensated employees consisting of three individuals is permitted average deferrals of six percent after application of the special nondiscrimination tests. Because the deferrals by the three individuals are averaged, if two choose not to defer any compensation, the third individual could elect to defer 18 percent of compensation, which is 300 percent of the otherwise permitted average deferral. They suggest that, if Congress had intended such a result, it would have raised the IRA deduction limit rather than enacting rules for cash or deferred arrangements.

Amount of differential

Some argue that the Administration proposal is inappropriate because it continues to permit higher participation by highly compensated employees than by rank-and-file employees. This group proposes to require cash or deferred arrangements to have no differential between the rate of participation by the highly compensated and the rate of participation by the rank-and-file employees. Under this proposal, the percentage deferral by each highly compensated employee could not exceed 100 percent of the deferral percentage for all other employees.

Alternatively, some suggest that no differential should be permitted if the employer also maintains a qualified plan that is integrated with social security. Those who support this approach point out that integrated plans are weighted in favor of highly compensated employees and argue that it is inappropriate to permit a cash or deferred arrangement of the employer to also be weighted in favor of highly compensated employees through the application of the special nondiscrimination tests. Others point out, however, that some differential may be justified if benefits rather than contributions are tested for discrimination.

On the other hand, some argue that the special nondiscrimination rules currently applicable to cash or deferred arrangements are clearly sufficient to prevent any abusive use of the plans for highly compensated employees. They point to the experience of many employers who use matching contributions to get significant participation by the rank-and-file employees. They also contend that the present law tests are more appropriate because they permit greater deferrals by older workers, who have a greater need to save for retirement and who tend to be more highly compensated.

Some also argue the Administration proposal inappropriately reduces the flexibility of cash or deferred arrangements while expanding the tax incentives for IRAs by increasing the spousal IRA deduction limit.

It has been suggested that the special nondiscrimination test would be substantially less complex if the test had only one requirement (such as the 125 percent rule) and did not allow satisfaction of the alternative rule (the 200 percent/two percentage point rule). Others contend that the two-pronged test allows needed flexibility for plans, especially in the years immediately following plan establishment, in which deferral levels are relatively low and the 200 percent/two percentage point test would otherwise permit higher deferrals. On the other hand, if the deferrals of the low paid are low, some suggest that a proportionate limit on the deferrals of the highly compensated employees is appropriate.

Definition of highly compensated employees

The Administration proposal would redefine the group of employees in whose favor discrimination is prohibited under a qualified cash or deferred arrangement. Under present law, this group is the top 1/3 of employees by compensation. Some believe that the top 1/3 of employees may include nonhighly compensated employees. They also suggest that the special nondiscrimination test, by looking at average deferrals for each group, may permit highly compensated employees to make greater deferrals because of lower deferrals by the nonhighly compensated employees who are in the top 1/3 group.

For a detailed discussion of the issues relating to the definition of highly compensated employees, see the discussion on Nondiscrimination Rules in Part III. A., below.

Effect of withdrawal restrictions

Present law imposes withdrawal restrictions with respect to elective deferrals and certain employer matching and nonelective contributions under a qualified cash or deferred arrangement.

Some believe that withdrawal restrictions are appropriate for tax-favored retirement savings arrangements. They argue that, if withdrawals can be made from these programs at any time or for any reason, then people will treat them as ordinary savings accounts with favorable tax features. They also argue that it is inappropriate to require taxpayers who are unable to accumulate significant savings to subsidize the general purpose savings of those who are more fortunate.

Proponents of restrictions on withdrawals contend that they operate to assure a source of long-term capital that is needed by the economy. They also argue that the restrictions are needed to prevent these savings arrangements from competing unfairly with investment media subject to less favorable tax treatment.

Some believe that withdrawal restrictions constitute an inappropriate impediment to savings. This group argues that individuals are less likely to elect to save for retirement in lieu of electing current wages if they do not have easy access to their benefits. They believe that low- and moderate-income people cannot afford to commit savings to an arrangement under which withdrawals are not permitted for an extended period. Accordingly, they argue that withdrawal restrictions discourage many people from participating in qualified cash or deferred arrangements. They believe that elimination of the restrictions would lead to an increase in the level of retirement savings because people will make larger contributions and would not make inappropriate withdrawals before retirement.

Others counter this argument by pointing out that the absence of withdrawal restrictions may lead to greater short-term savings, but would not create any true increases in retirement savings. Under this view, low-income taxpayers, who are more likely to save if they have access to their funds, will withdraw tax-favored savings in order to meet current consumption needs. Some argue that middle- and upper-income taxpayers, who have a greater propensity to save without regard to the existence of restrictions on access, would not save more on a tax-favored basis merely because there were no withdrawal restrictions.

Some hold the view that retirement savings should not be singled out for favorable tax treatment. Thus, some argue that savings for higher education are as important as savings for retirement and should also be encouraged by the tax law. Others believe that tax-favored treatment should also be accorded to savings for the purpose of acquiring a home. Under this view, it has been suggested that, even if tax-favored retirement arrangements have restrictions on withdrawals before retirement, exceptions should be provided to permit withdrawals for specific nonretirement purposes.

On the other hand, opponents of this view believe that rules permitting nonretirement withdrawals for specific purposes are difficult to administer. They point to the fact that the IRS has provided conflicting guidance on what constitutes a hardship and suggest that it would be difficult to develop an administrable standard, which is not subject to abuse. The opponents also argue that government support of other social goals, such as higher education, should also be addressed separately so as not to provide a mechanism to undermine the retirement security goal of qualified plans. They argue that the fact that retirement is so distant in time and of such uncertain duration makes it a unique problem that should be treated separately under the tax laws.

Others point out that the Administration proposal list of items that deserve special consideration for purposes of reducing the restrictions on early withdrawals may not be exhaustive. They suggest that there may be other circumstances under which it is appropriate to reduce the restrictions.

Defined benefit plans vs. defined contribution plans

Some believe that the Administration proposals with respect to cash or deferred arrangements are appropriate because they reduce the relative attractiveness of defined contribution plans. Those who support this approach argue that defined benefit pension plans provide better overall retirement income security because the participants in defined benefit pension plans are protected against bad investment experience. Also, they point out that many defined benefit pension plans provide protection against inflation up to normal retirement age because the benefits provided are based on final average pay.

Some believe that defined benefit pension plans provide greater retirement security because they provide a more predictable level of benefits. They are concerned that the effect of legislation in recent years, such as the adoption of the rules relating to cash or deferred arrangements in 1978, has been to make defined contribution plans more attractive than defined benefit pension plans. They also point out that the substantial growth of cash or deferred arrangements in the last few years demonstrates this trend.

Those who favor defined contribution plans point out that defined benefit pension plans do not necessarily provide the best form of retirement savings for some employees, such as young, mobile employees. This group argues that the best approach to retirement income security is for employers to offer both types of plans to employees. They believe that the trend toward adopting cash or deferred arrangements in recent years is a reflection of an employer shift toward providing more than one type of plan, rather than a shift from defined benefit pension plans to defined contribution plans. They argue that significantly reducing this trend by making cash or deferred arrangements less attractive will only hurt those younger, more mobile employees who would otherwise benefit.

Some favor defined contribution plans because they shift the burden of saving to the individual. Those favoring an individual approach to benefit protection argue that it is better to give individuals the responsibility of making their own arrangements for income security during retirement years. This group believes that individuals should finance their own plans for retirement and argue that a qualified cash or deferred arrangement accomplishes this result.

Others contend that access to tax-favored savings does not, in itself, create equity. They argue that discretionary plans, such as qualified cash or deferred arrangements, do not eliminate the primary restriction on savings for low-paid employees, that is, the lack of discretionary income. Those who support this view believe that group plans without employee choice offer greater security, lower costs, more convenience, and a disciplined approach to savings and risk protection.

Cash or deferred arrangements for tax-exempt organizations and governments

Some have criticized the Administration's proposal to limit the availability of cash or deferred arrangements to private employers. This group criticizes the proposal as an unnecessary cutback of present law. They point out that some States, such as Tennessee, have received determination letters concluding that their cash or deferred arrangements are qualified. In addition, a General Counsel Memorandum issued by the Office of Chief Counsel of the IRS has taken the position that tax-exempt organizations can maintain profit-sharing plans, which would generally lead to the conclusion that they also may maintain profit-sharing plans that include cash or deferred arrangements.

Some have argued that the elimination of cash or deferred arrangements for tax-exempt organizations and governments results in inequitable treatment for the employees of such organizations and may impair the ability of the organizations to attract qualified employees. They question why tax-exempt organizations should be denied cash or deferred arrangements if Congress believes their use generally should be encouraged.

Those who support the Administration proposal argue that, by originally limiting cash or deferred arrangements to profit-sharing and stock bonus plans, Congress intended to limit their availability to taxable employers. Further, they point out that Congress has recently considered the use of a cash or deferred arrangement as part of a money purchase pension plan and specifically limited that use to certain pre-ERISA money purchase pension plans.

There are those who argue that the profit requirement in "profit-sharing" plans does not serve a useful purpose, especially if such plans are viewed as retirement plans. The concept of a profit-sharing plan could be replaced by a discretionary contribution plan

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that then could be maintained by any employer, including tax-exempt organizations and governments.

Employee flexibility

In conjunction with a legislative review of the rules applied to qualified cash or deferred arrangements, some have suggested that consideration be given to the extent to which employee choice in choosing his or her benefit or contribution levels or options should cause part or all of a plan to be considered a cash or deferred arrangement.

C. Employer Matching Contributions and Employee Contributions

Present Law and Background

Under present law, a qualified plan may permit employees to make either after-tax or pre-tax contributions to a qualified plan. Employee contributions to a qualified plan may be voluntary or mandatory. Mandatory contributions include those made as a condition of obtaining employer-derived benefits (e.g., employee contributions made as a condition of obtaining matching employer contributions).

Present law provides that a qualified plan may not discriminate in either contributions or benefits in favor of employees who are officers, shareholders, or highly compensated. Generally, this nondiscrimination requirement is satisfied with respect to employee contributions if all employees are entitled to make contributions on the same terms and conditions. In the past, voluntary employee contributions have been permitted if all participants are eligible to make contributions and if no employee is permitted to contribute more than 10 percent of compensation, determined based on aggregate contributions and compensation during the period of participation.

Employer matching contributions are required to satisfy the usual nondiscrimination rules applicable to qualified plans, which prohibit a plan from discriminating in either contributions or benefits in favor of employees who are officers, shareholders, or highly compensated. A plan is not considered nondiscriminatory if contributions on behalf of employees are a uniform percentage of compensation. Social security contributions of an employer generally can be taken into account in determining whether contributions constitute a uniform percentage of compensation or a nondiscriminatory benefit.

If employer matching contributions are made in connection with elective deferrals under a qualified cash or deferred arrangement and the matching contributions are nonforfeitable and subject to the withdrawal restrictions for elective deferrals, then the matching contributions may be taken into account in applying the special nondiscrimination tests applicable to qualified cash or deferred arrangements.

Administration Proposal

Under the Administration proposal, special nondiscrimination rules would be applied to employer matching contributions under all qualified plans. These two nondiscrimination tests would apply in lieu of the usual nondiscrimination rules applicable to qualified plans.

Under the first test, if employer matching contributions are qualifying matching contributions, the special nondiscrimination tests applicable to qualified cash or deferred arrangements would apply to the matching contributions. In order to be qualifying matching contributions, the matching contributions would be required to be (1) nonforfeitable when made, (2) ineligible for withdrawal prior to the employee's death, disability, separation from service, or plan termination, and (3) no greater than 100 percent of the employees' mandatory contributions.

If qualifying matching contributions are tied to the elective deferrals under a qualified cash or deferred arrangement, the elective deferrals, when combined with the matching contributions, would be required to satisfy the special nondiscrimination tests applicable to qualified cash or deferred arrangements.

The proposal would provide that nonqualifying matching contributions are treated as elective deferrals and, for any highly compensated employee, are to be limited to the greater of (1) 110 percent of the deferral percentage for the nonhighly compensated employees or (2) the lesser of 150 percent of the deferral percentage for nonhighly compensated employees or the deferral percentage for nonhighly compensated employees plus one percentage point. If the nonqualifying matching contributions are tied to elective contributions under a qualified cash or deferred arrangement, then the matching contributions would be combined with the elective deferrals under the cash or deferred arrangement and both would be subject to the special nondiscrimination test for nonqualifying matching contributions.

Under the proposal, if the special nondiscrimination test for matching contributions is not satisfied, the excess matching contributions are treated in the same manner as excess elective deferrals under a cash or deferred arrangement. Thus, the matching contributions in excess of what would be permitted under the special nondiscrimination test would be treated as a nondeductible employer contribution. The excess contributions would be subject to the excise tax on contributions in excess of the deduction limits (see discussion of Employer Deductions in Part V. B., below). In addition, excess elective deferrals would be required to be distributed by the end of the plan year following the plan year to which the deferral relates to avoid disqualification of the plan.

Analysis

Employer matching contributions are generally provided in qualified plans as an added incentive for employees to save for their own retirement on either a pre-tax or after-tax basis. The Administration proposal would impose special nondiscrimination requirements on employer matching contributions, which compare actual employer matching contributions for highly compensated employees vis-a-vis employer matching contributions for all other employees. These requirements are designed to ensure that employer matching contributions generally benefit broad classes of employees and not merely the highly compensated, who are more likely to save without regard to the tax incentives.

Some have argued that employers use matching contributions in order to shift the cost of retirement benefits from the employer to the employees. This, they suggest, should only be permitted if employers are subject to strict restrictions on who is entitled to receive matching contributions. Proponents of these restrictions claim that employer matching contributions should not disproportionately benefit highly compensated employees. Those who support the Administration proposal assert that it is necessary to impose utilization requirements on employer matching contributions to preclude the provision of a greater tax benefit to highly compensated employees with respect to the tax-deferred growth under a qualified plan.

Some have suggested that the Administration proposal does not adequately reduce the tax benefits associated with employer matching contributions. They question whether it is appropriate to permit employers to maintain both a qualified cash or deferred arrangement and another plan with mandatory employee contributions. They assert that the special nondiscrimination tests will not be effective if employers can avoid them by maintaining more than one plan. Those who support this view argue that all employer matching contributions on behalf of any employee should be aggregated for purposes of testing whether the special nondiscrimination requirements are met.

Others argue that it is inappropriate to permit any differential between the contributions (as a percentage of compensation) made on behalf of highly compensated employees and the contributions (as a percentage of compensation) made on behalf of all other employees. They suggest that the usual nondiscrimination rules, which require that employer contributions must be a uniform percentage of compensation, should be applied to employer matching contributions. (For a discussion of whether social security contributions or benefits may be taken into account, see Minimum Standards Under Qualified Plans, Part III. A., below.)

On the other hand, opponents of the Administration proposal suggest that the present law nondiscrimination test for matching employer contributions, which requires that such contributions meet the usual nondiscrimination rules for qualified plans, is adequate to prevent any abuse. They suggest that the proposed special nondiscrimination test for employer matching contributions adds a significant additional layer of complexity to the nondiscrimination standards applicable to qualified plans. Others point out that the proposed test is more liberal than present law and easier to apply, as it allows averaging of the contributions made on behalf of the highly compensated employees.

Others contend that the Administration proposal penalizes employers who provide employer matching contributions under a plan in which employees make after-tax rather than pre-tax contributions. They point out that this occurs because employer matching contributions are subject to the same nondiscrimination rules, regardless of whether the mandatory employee contributions are made on a pre-tax or after-tax basis. Some argue that, if Congress is concerned with the revenue loss attributable to qualified cash or deferred arrangements, it would be more appropriate to continue more liberal nondiscrimination rules for employer matching contributions under a plan other than a qualified cash or deferred arrangement. They propose that an alternative to the Administration proposal would be to apply the present-law rules for elective deferrals under a qualified cash or arrangement to employer matching contributions under a plan other than a qualified cash or deferred arrangement.

Finally, some have suggested that it is appropriate to evaluate whether any additional nondiscrimination tests should be imposed on employee contributions other than elective deferrals under a qualified cash or deferred arrangement. Those who support further limitations on employee contributions (whether or not deductible) argue that it is important to limit the availability of tax-favored savings for highly compensated employees unless all other employees are participating. They argue that special nondiscrimination rules, which measure the differential between contributions by highly compensated employees and contributions by all other employees, should be applied to all employee contributions regardless of whether they are voluntary or mandatory. They believe that a proposal to restrict the ability of employees to make employee contributions is consistent with the Administration proposal to repeal the tax deferral of earnings under a nonqualified deferred annuity contract.

Others believe that the restrictions on employee contributions under present law are adequate to limit the extent to which any individual can use a qualified plan for tax-favored savings. They point out that employee contributions are partially taken into account in calculating the limit on annual additions on behalf of any employee. Further, they note that present law imposes limitations on the amount of employee contributions under present law.

D. Unfunded Deferred Compensation Arrangements of State and Local Governments and Tax-Exempt Employers

Present Law and Background

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. An individual is treated as having constructively received compensation during the current taxable year if the compensation would have been payable during the current taxable year but for the individual's election to defer receipt of the compensation to a later taxable year (Prop. Reg. sec. 1.61-16).

An exception to this rule applies to compensation deferred under a nonqualified and unfunded deferred compenastion plan of a taxable employer (sec. 132 of the Revenue Act of 1978). Under this exception, the year of inclusion in income of deferred compensation is determined under the principles set forth in rulings, regulations, and judicial decisions relating to deferred compensation that were in effect on February 3, 1978.

In addition, a special provision of present law exempts from the general principle of constructive receipt certain amounts deferred under an eligible unfunded deferred compensation of a State or local government (sec. 457). Under present law, certain tax-exempt rural electric cooperatives are eligible for this special provision, but other tax-exempt organizations are not.

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) 33-1/3 percent of compensation (net of the deferral). 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, distributions must be made primarily for the benefit of participants, rather than beneficiaries. Under this rule, the total amount of payments scheduled to be made to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary. This rule differs from the incidental benefits rule applicable to qualified plans under which the amount payable during a participant's lifetime must be projected to exceed 50 percent of the total amount payable with respect to the participant.

Deferrals under a funded 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.[7]

Administration Proposal

Under the Administration proposal, the definition of an eligible State or local deferred compensation plan would be expanded to permit employees of all tax-exempt employers to be eligible for these plans.

The proposal would also modify the distribution restrictions for eligible deferred compensation plans. As modified, distributions under an eligible deferred compensation plan would be required (1) to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66-2/3 percent

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[7] Prop. reg. sec. 1.61-16 provides that amounts deferred pursuant to an individual's election are includible in gross income when they would have been payable absent the election even if they are subject to a substantial risk of forfeiture on deferral.

of the total benefits payable with respect to the participant, (2) in the case of benefits payable over a period of more than 1 year, to be paid on a substantially nonincreasing basis, and (3) after the death of the employee, to provide for the commencement of benefits to the employee's beneficiary within 1 year after the employee's death.

In addition, the proposal would provide that benefits are not treated as made available under an eligible deferred compensation plan merely because an employee is allowed to elect to receive a lump sum payment of all benefits deferred, provided the payment is made within 60 days of the election. However, this rule only applies if the employee's total deferred benefit does not exceed $3,500 and the employee is no longer entitled to elect deferrals under a plan of the same employer.

Finally, the Administration proposal would permit certain rollovers of benefits between eligible deferred compensation plans.

Analysis

Eligible plans

Proponents of the Administration proposal to develop uniform rules for nonqualified deferred compensation arrangements maintained by tax-exempt entities and governments argue that there is no need to create distinctions between governmental and nongovernmental entities. They note that it is inappropriate to apply constructive receipt principles to employees of nongovernmental entities, thereby precluding their ability to fund deferred compensation arrangements on a salary reduction basis, while simultaneously permitting salary reduction for certain government employees. They would extend the present-law rules for eligible governmental plans (sec. 457) to all tax-exempt employers.

Those who support the Administration proposal point out that special limits should be maintained for deferred compensation for employees of tax-exempt organizations and governmental entities because the usual tension between an employee's desire to defer tax on compensation and the employer's desire to obtain current deductions is not present.

On the other hand, opponents of the proposal point out that the same problem (i.e., lack of tension) exists in the case of a taxable employer who has operating losses. They argue that it is inappropriate to penalize employees of nontaxable entities merely because of the status of the employer. They further note that such a proposal is inconsistent with the Administration proposal to limit the access of tax-exempt entities to qualified cash or deferred arrangements. Opponents of the proposal argue that it is more appropriate to permit tax-exempt employers to maintain qualified cash or deferred arrangements under which participants would be entitled to the protections afforded by ERISA.

Required distributions

Proponents of the Administration proposal to apply minimum distribution rules to nonqualified deferred compensation plans maintained by tax-exempt employers argue that the plans are intended to permit savings for retirement purposes, rather than accumulations to be transferred upon death to a participant's heirs. To ensure that the savings are used for retirement purposes, they suggest that it is necessary to require minimum distributions during a participant's lifetime. To further limit deferral after the participant's death, they also argue that post-death distribution rules should mandate distribution within one year of the participant's death. They also point out that distribution requirements are particularly appropriate to preclude nonqualified arrangements from receiving the benefit of deferral for a longer period than is permitted under a qualified plan.

Opponents of the Administration proposal argue that the addition of minimum distribution rules imposes unnecessary complexity and administrative burdens on the employer. In addition, they argue that the Administration proposal to require a schedule of payments under which more than 66-2/3 percent of the projected total benefit is scheduled to be made to the participant during the participant's lifetime may require that distributions from these nonqualified arrangements be made more rapidly than distributions under qualified plans.

Taxation of nonqualified deferred compensation

Some argue that the primary benefit of qualified plans is the tax-deferred build-up on the amounts in the plan. Based on this premise, they further argue that employers that are not subject to tax for any reason are able to provide, through nonqualified deferred compensation, the benefits that are supposed to be restricted to qualified plans. Proponents of this argument suggest that nonqualified deferred compensation should be subject to a tax to retain incentives for an employer to maintain qualified plans.

Opponents of such a position note that any such proposal would be very complicated. They further note that such a proposal is inconsistent with the Administration proposal to limit the access to tax-exempt entities to qualified cash-or-deferred arrangement.

III. MINIMUM STANDARDS FOR QUALIFIED PLANS

A. Nondiscrimination Rules

General Background

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 first 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,[8] 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 indicated that 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 . . .".[9] 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 (coverage rules) intended to prevent a plan from qualifying if it failed to cover a fair cross-section of the employees of an employer. Coverage is only one of the prerequisites to receiving pension benefits. The extent to which benefits are provided in a nondiscriminatory fashion and the extent to which the employee earns a nonforfeitable right to receive promised benefits are equally significant in determinig whether an employee is entitled to a pension benefit. The 1942 Act also prohibited contributions or benefits provided under a qualified plan from discriminating in favor of employees who are highly compensated (rules requiring nondiscriminatory benefits). In applying the rules requiring

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[8] 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).

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

nondiscriminatory benefits, the Act also provided rules permitting the coordination of qualified plans with social security (integration rules). Vesting rules were subsequently made more restrictive by the enactment of the Employee Retirement Income Security Act of 1974 (ERISA). (See the discussion below.)

1. Coverage

Present Law and Background

As subsequently modified by ERISA, the coverage requirements applicable to qualified plans (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 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 low-compensation brackets are covered in more than nominal numbers.[10]

Aggregation rules

Controlled groups.—In applying the qualification rules (including both the percentage and fair cross-section coverage tests), all employees of corporations that are members of a controlled group of corporations, or all employees of trades and businesses (whether or not incorporated) that are under common control, are aggregated and treated as if employed by a single employer (sec. 414(b) and (c)).

Affiliated service groups.—Similarly, all employees of employers that are members of an affiliated service group are treated as em-

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

ployed by a single employer for purposes of the qualification requirements (sec. 414(m)). An affiliated service group consists of a service organization (the "first organization") and (1) each other service organization that is related to the first organization and (2) each other organization that is related to either the first organization, or to a service organization that is related to the first organization. In determining whether a group of employers constitutes an affiliated service group, certain attribution rules apply.

Employee leasing arrangements.—For purposes of certain of the tax-law rules for qualified plans and SEPs, an individual (a leased employee) who performs services for another person (the recipient) is treated as the recipient's employee if 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 (sec. 414(n)). The individual is treated as the recipient's employee only if the individual has performed services for the recipient (or for the recipient and persons related to the recipient) on a substantially full-time basis for a period of at least 12 months, and if the services are of a type historically performed by employees in the recipient's business field.

However, under a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee pursuant to these rules is not treated as such an employee if certain requirements are met with respect to contributions provided for the individual under a qualified money purchase pension plan maintained by the leasing organization (sec. 414(n)(7)). The safe-harbor rule is inapplicable to a leased employee who is otherwise a common-law employee of the recipient.

Other aggregation.—The Secretary of the Treasury also has the regulatory authority to develop any rules as may be necessary to prevent the avoidance of any employee benefit requirement to which the employee leasing or affiliated service group provisions apply through the use of employee leasing or other arrangements (sec. 414(o)).

Excludable employees

In applying the percentage test, certain employees who have not yet completed minimum periods of service (generally one year)[11] 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 test, employees included in a unit of employees covered by an agreement that the Secretary of Labor finds to be a collective bargaining agreement between employee representatives[12] and one or more employers are disregarded if they are excluded pursuant to a plan provision if there is evidence that retirement benefits were the subject of good faith bargaining between such employee representatives and the employer or employers (sec. 410(b)(3)(A)). Certain non-

[11] Under a special rule, an employee may be excluded from participation for up to three years provided the employee is, after three years, fully and immediately vested.

[12] An organization is not considered to be an employee representative if more than one-half of its members participating in the plan are employees who are also owners, officers, or executives of the employer.

resident aliens and certain airline employees must be excluded (sec. 410(b)(3)(B) and (C)).

Tax-sheltered annuities

Under present law, no coverage or nondiscrimination rules prohibit an employer's tax-sheltered annuity program from favoring highly compensated employees.

Administration Proposal

In general

The Administration proposal would (1) redefine the group of employees in whose favor discrimination is prohibited (highly compensated employees); (2) repeal the present-law percentage and classification tests for testing coverage; and (3) create a single new coverage test applicable to all qualified plans.

Highly compensated employees

Under the proposal, an employee would be treated as highly compensated with respect to a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee (1) owns an interest of at least one percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) earns at least $20,000 in compensation and is among (a) the top 10 percent of employees by compensation, or (b) the top three employees by compensation; or (4) is a family member of another prohibited group member for such year.

Coverage test

Under the proposal, the percentage of highly compensated employees participating in a plan would be computed. That percentage would be compared to the corresponding percentage of other employees who participate in the plan. The percentage for highly compensated employees generally would not be permitted to exceed 125 percent of the percentage calculated for other employees.

For example, an employer who wished to provide benefits for each of the highly compensated employees would be required to provide benefits to at least 80 percent of the nonhighly compensated employees. This is because 100 percent (the ratio of highly compensated employees benefiting under the plan to all highly compensated employees) does not exceed 80 percent (the corresponding ratio calculated for nonhighly compensated employees) by more than 125 percent.

In addition, under the proposal, in very limited situations where compelling business reasons indicate that application of the 125-percent test would not be appropriate (e.g., for a limited period following a significant change in the employer's workforce), an employer would be permitted to obtain a timely ruling from the Internal Revenue Service that the employer's plan satisfies the nondiscriminatory coverage test even though it fails to satisfy the 125-percent test. The Internal Revenue Service would be permitted to impose any reasonable conditions on the continued validity of such a ruling.

Aggregation of employers

The proposal would continue to apply the present-law rules for controlled groups, affiliated service groups, and leased employees.

Excludable employees

The proposal would narrow the class of employees that could be excluded from consideration in applying the 125-percent test. Unlike present law, those employees with less than three years of service (who may be excluded from participation if the plan provides full and immediate vesting) may not be excluded in applying the coverage tests. In addition, certain airline employees could no longer be excluded.

The proposal would require the exclusion of employees not covered by the plan who are covered by certain collectively bargained agreements and of certain nonresident aliens.

Possible Proposals

In general

As an alternative to the Administration proposal, it has been suggested that coverage could be expanded by repealing the fair cross-section test and requiring that a qualified plan benefit a higher percentage of all employees. For example, a qualified plan could be required to cover a higher percentage (some suggest 100 percent) of all employees other than excludable employees.

Tax-sheltered annuities

It has been suggested that coverage and nondiscrimination requirements under the Administration proposal should be extended to apply to tax-sheltered annuity programs.

Analysis

Coverage tests originally were provided in 1942 to require qualified plans to benefit a substantial percentage of an employer's employees, or a broad, nondiscriminatory cross-section of employees. The appropriateness of the existing rules has been questioned. Some argue that neither 70 percent nor 56 percent of the employer's workforce necessarily constitutes a broad cross-section. In addition, they question why these percentage tests should permit the complete exclusion of the lowest paid 30 percent or 44 percent of the employer's employees and why an employer should be permitted to cover 100 percent of the highly compensated group without covering 100 percent of all employees.

Definition of highly compensated employee

In general.—Under present law, an employee who is an officer, shareholder, or highly compensated is considered a highly compensated individual in whose favor discrimination is prohibited. Some pension experts argue that these terms generally lack definition and, therefore, create standards that are imprecise and unadministrable. For example, they point to the term "officer." To determine whether an employee is an officer requires a subjective evaluation of each potential officer's status (both in name and in authority), including the source of the officer's authority, the term of office, and the nature of the officer's duties.

While determining the status of an employee as a shareholder generally is easier, some question whether it is appropriate to treat all shareholders as highly compensated, regardless of their level of ownership or level of compensation.

With respect to the definition of an employee as highly compensated, they point out that judicial and administrative precedent provides that the compensation level that makes an employee "highly compensated" depends on the facts and circumstances of each situation. An employee whose compensation is high, relative to the compensation of other employees of the employer, is considered highly compensated. This result occurs regardless of the actual dollar level of compensation and regardless of whether that compensation would otherwise be considered high in another industry or area.

Considering all of these ambiguities in present law, many support, in concept, a proposal to develop a uniform, more mechanical definition of a highly compensated individual. Under the Administration proposal, an employee is considered highly compensated if the employee (1) owns an interest of at least one percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) is earning at least $20,000 in compensation and is among (a) the top 10 percent of employees by compensation, or (b) the top three employees by compensation; or (4) is a family member of another prohibited group member for such year.

Those who support the proposal argue that it more narrowly defines the group of highly compensated employees. They also argue that the new definition is objective, providing precise, easily administrable guidance. Some also argue that adoption of a mechanical test may permit the development of a sanction, other than plan disqualification, for plans that did not meet the test.

Definition of owner.—Others who argue that a more objective definition is appropriate question certain aspects of the Administration proposal. They question, for example, why the proposal includes a new definition of owner. If uniformity is a desirable goal, they suggest it may be more appropriate to conform the ownership definition used for testing coverage with that already used for determining whether a plan is top heavy. Under this approach, five-percent owners, certain one-percent owners earning more than $150,000, and the top-ten employee owners would be considered highly compensated by virtue of their ownership interest.

Some suggest that an owner should be considered a highly compensated employee only if the employee is a participant in the plan.

Employees earning more than $50,000.—Some question whether application of a dollar threshold is appropriate to identify those individuals in whose favor discrimination is prohibited. They suggest that individuals with high salary levels may not control the employer or have any influence over the plan. Some also argue that the existence of a dollar threshold adds unnecessary complexity.

Others argue, however, that qualified plans receive tax benefits to encourage employers to provide retirement benefits for low- and middle-income employees. Accordingly, the definition of individuals in whose favor discrimination is prohibited serves to identify not only those employees who control the employer, but also those employees who are perceived to be highly paid. Consistent with this goal, a compensation threshold is necessary and no qualified plan should be permitted to discriminate in favor of those earning more than that dollar amount. They argue that this not only helps to focus the tax incentives toward low- and middle-income employees, but also prevents a perception of unfairness. If qualified plans provide benefits to individuals who are perceived to be highly compensated (even if they do not control the employer) without providing the same benefits to low-paid employees, it is argued that low paid employees will view present law as unfair.

Some who favor use of a dollar threshold question whether an individual earning $50,000 is, in reality, highly compensated in all circumstances. In certain businesses, such as law firms, medical practices, and certain high-technology electronic industries, some employees (or associates) start at or near the $50,000 threshold. In some cases, a majority of employees would be considered highly compensated using the $50,000 threshold. Some question why it is appropriate to include the majority of employees in the highly compensated group.

Those supporting broader coverage also point out that, if these individuals are considered highly compensated, it may be very easy to manipulate the proposed coverage test. For example, if all associates of a law firm were considered highly compensated, the firm could cover all the partners and, by excluding the highly compensated associates, could reduce the number of other employees required to be covered. This group suggests that, in some instances, the compensation threshold used to determine highly compensated status should be increased. For example, if more than thirty percent of the workforce earn more than $50,000, it may be appropriate to provide that only those individuals earning more than some higher amount (e.g., $75,000) would automatically be considered highly compensated.

Top-ten percent.—Some are also concerned about the proposal to treat as highly compensated an individual earning at least $20,000, provided the individual is among the top-ten percent by compensation of employees or the top-three employees. Proponents argue that this test is needed to ensure that there is always some individual who is highly compensated relative to other employees. They point out that in some areas or industries, no employee earns as much as $50,000. They argue that the Administration proposal to treat the top-ten percent or the top-three employees as highly compensated is appropriate.

Others argue that a test based on the top percentage of employees by compensation is too difficult to administer, especially because they must determine this status for the current year and two preceding years. As any employee enters or leaves the workforce, it would affect the calculation, possibly changing the group in the top-ten percent. These problems would be exacerbated for larger employers with employees at many locations and on multiple payrolls. Others argue that $20,000 may not represent a high level of compensation, even within a given industry. They suggest that it may be appropriate to develop an additional rule excluding certain employees from the highly compensated group if, for example, they earned less than $35,000 and were not among the top-five percent of employees.

Others argue that application of the top-three employee test creates difficulties, especially in the context of a small workforce. Some suggest that it would be more appropriate to require that a plan cover the lesser of a specified number of employees (e.g., 50 employees) or the total number of employees who are not excludable by reason of age, service, etc.

Family members.—Some question whether family members of every highly compensated employee should be considered highly compensated. They point out that, in a large corporation or a controlled group, with many diversified businesses, employers would be forced to determine whether a family member of any highly compensated employee is also an employee of the employer. They suggest that the recordkeeping burden would be extremely difficult. They also point out that family members of owners generally would be included through the attribution rules, so they question why this separate test is necessary.

Some who favor broader coverage also suggest that, if all family members are considered highly compensated, it may be very easy to manipulate the proposed coverage test. For example, an owner could add family members to the payroll, exclude them from participation, and reduce the number of other employees required to be covered. This group would suggest that family members be considered highly compensated only if they are participants in the plan or are otherwise separately determined to be highly compensated (e.g., because their compensation exceeds $50,000, or because they are owners of the employer). Still others suggest that it may be appropriate to count family members only of the top-20 highly compensated employees.

Lookback period.—Under the Administration proposal, an individual's status as a highly compensated employee is determined by examining his ownership and compensation levels during a three plan year period. Thus, an individual will be treated as a highly compensated employee with respect to a plan year if the individual was a highly compensated individual at any time during the three plan year period ending on the last day of the plan year for which coverage is being tested.

Those favoring the extended testing period argue that status determinations based only upon one year may cause significant fluctuations in the composition of the highly compensated group. They also believe a single year test could be easily manipulated to the advantage of certain highly compensated employees.

Others argue, however, that it is inappropriate to include the year for which the test is applied in the testing period. They suggest that a test including the current year makes it difficult to finally identify the highly compensated group before the last day of the plan year, thus making it difficult to determine coverage for the year. They suggest that it may be more appropriate to use a lookback period that ignores the current year and ends instead on the last day of the preceding plan year. This would fix the highly compensated group at the beginning of the year, making it easier to comply with the coverage requirements without requiring employers to monitor employee changes within the current year.

Proponents of the Administration proposal argue, however, that it is important to match the identification of highly compensated employees with the current workforce. They believe it is appropriate to require consideration of the current year. They also point out that use of a 125-percent rather than a 100-percent ratio provides some flexibility to compensate for current year changes in the workforce.

They also point out that if the current year is ignored, a newly hired employee who otherwise would be considered highly compensated could receive very large accruals in that first year. Including the employee in the highly compensated group in the second year would not correct this discriminatory accrual.

Percentage tests

With respect to the present-law percentage tests, those seeking to require expanded coverage argue that neither 70 percent nor 56 percent of the employer's employees assures coverage of a broad cross-section of low- and middle-income employees; and (2) that the percentage tests inappropriately measure coverage by determining a percentage of the total workforce rather than comparing coverage of the prohibited and nonprohibited groups. They assert that the employees most likely to be omitted from coverage are the low- or middle-income workers.

Those who favor broader coverage suggest that the percentage limits could be increased. Some argue that an employer should be required to cover 100 percent of the employees who satisfy the minimum age and service requirements. They point out that minimum age and service requirements may be appropriate to exclude very young or short-service employees, but they question why an employer should also be permitted to arbitrarily exclude an additional percentage of employees who meet these age and service requirements. They also note that any percentage test requiring less than 100 percent coverage might still work to the disadvantage of low- or middle-income workers.

Proponents of the Administration proposal argue that elimination of the percentage tests would tend to promote better coverage of low- and middle-income employees. They suggest that it is more appropriate to test coverage by comparing the coverage percentage of highly compensated employees with that of other employees. They note that, under the present-law percentage tests, an employer with 100 employees, consisting of 20 highly compensated employees and 80 other employees, would satisfy the 70-percent test by covering 70 employees, consisting of all of the highly compensated employees (100 percent) and only 50 of the 80 other employees (62.5 percent).

Alternatively, the employer could satisfy the 70-80-percent test by covering 56 employees, consisting of all of the highly compensated employees (100 percent) and as few as 36 of the other employees (45 percent), provided at least 50 of the other employees are eligible to participate. Consequently, some argue that tests which permit an employer to benefit 100 percent of the highly compensated group while benefiting a much lower percentage of nonhighly compensated employees cannot be expected to encourage nondiscriminatory coverage.

Those opposing expansion of the present-law coverage requirements believe that the Code is designed to provide incentives for employers to maintain qualified plans, rather than to compel mandatory retirement benefits. They point out that plans are required to provide benefits for a "significant percentage of employees," not "all employees." In a system in which the employer's decision to adopt or maintain a plan is voluntary, they are concerned that imposing broader coverage rules may cause plan termination because benefits might otherwise be prospectively reduced to de minimis levels if coverage is expanded and costs are held constant. On the other hand, proponents of broader coverage argue that the cost of providing benefits for the lower-paid employees who generally are younger is often very small. They also argue that the cost of broader coverage could be recovered through future reductions in excessive benefits for highly compensated employees.

Fair cross-section test

With respect to the fair cross-section tests, those seeking to require expanded coverage argue that the subjectivity of the present-law test creates anomalous results. Aggressive taxpayers willing to take the chance of being audited may be unduly advantaged while more conservative taxpayers may be hampered in their compliance efforts by the lack of any mathematically precise guidelines. They would support a more objective, mechanical test.

Proponents of the Administration proposal also note that the present-law subjective test also may permit an employer to benefit 100 percent of the highly compensated employees while benefiting a much lower percentage of nonhighly compensated employees. In one revenue ruling, for example, an employer with a workforce of 150 employees established a plan covering only 40 employees. Although 100 percent of the 22 highly compensated employees (using the present-law definition) were participants, only 18 of the 128 nonhighly compensated employees, or 14 percent of those employees, were covered. Nevertheless, because the compensation of all but four of the 40 participants was substantially the same as those of excluded employees, and because the plan covered employees in all compensation ranges, the plan was considered to cover a fair cross-section of employees.[13]

Some question why a plan with such a disparity—100 percent of highly compensated employees compared with 14 percent of nonhighly compensated employees—should be permitted any tax benefits. They argue that the Administration proposal, on those facts, would require coverage of 80 percent of the nonhighly compensated employees (102 employees) and would provide a more effective application of the tax incentives to produce broad, nondiscriminatory coverage.

Opponents of the Administration proposal argue that the retention of a more subjective fair cross-section test is necessary because there are many instances in which an employer plan may cover a

[13] Rev. Rul. 83-58, 1983-1 C.B. 95.

significant number of employees, even though it does not benefit 70 percent or more of employees. They emphasize that compliance with the requirements of the Administration proposal may be particularly difficult for a large employer with diversified lines of business, both in an ongoing business situation and in the context of mergers and acquisitions. Such an employer may have separate plans for each line of business and some of its plans may differ according to the geographic area in which employees work. Each plan of such an employer may be designed to provide a level of benefits considered appropriate for that line of business or geographic locale. Often, the plans compare with the plans of other employers who compete for the same workforce either in the same industry or the same geographic locale.

Because the plans for the rank-and-file employees in each line of business are designed to provide benefits appropriate for that line of business, plans in different lines of business may provide benefits that are not comparable. Under present law, provided each plan covers a nondiscriminatory fair cross-section of employees, the plans need not be aggregated.[14]

Under the Administration proposal, however, any plan that does not, standing alone, meet the new coverage requirements would not be qualified unless that plan could be aggregated with other plans, thereby satisfying the coverage requirements on an aggregate basis. However, only comparable plans could be aggregated. Thus, the employer could be required to provide comparable benefits to employees in different geographic areas or different lines of business, whether or not those benefits were economically necessary from a business point of view, and regardless of whether those benefit levels were customary or appropriate for that industry. Opponents of the Administration proposal argue that this would artificially distort business decisions and compensation practices, especially in situations involving mergers and acquisitions.

Some proponents of the Administration proposal agree that application of any coverage rules, including the present-law rules,[15] on a controlled group basis necessarily involves certain administrative problems. They note that the Administration proposal deals with these concerns and concerns about necessary flexibility by permitting some disparity in the percentage of highly compensated participants covered by the plan versus nonhighly compensated participants covered by the plan. Absent the problems faced in the controlled group context, they suggest that the proposal should have required that the highly compensated employees' percentage not exceed 100 percent of the nonhighly compensated employees' percentage. In fact, some argue that employers should be required to cover all employees, other than excludable employees.

Though sensitive to the impact of coverage rules on a diversified business, some question whether distinctions based on another standard, such as some "line of business" or "geographic locale"

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[14] For a more complete discussion of comparability, see the discussion under Benefits and Contributions, Part III. A.2., below.

[15] See, e.g., *Fujinon Optical, Inc.* v. *Comm'r*, 76 U.S.T.C. 499 (1981) where a plan maintained by Fujinon Optical, Inc. (a distributor of highly sophisticated optical equipment) was ruled not to satisfy coverage because that plan did not cover a sufficient number of employees of the larger controlled group.

test are administratively feasible. Development and enforcement of a line of business test would require detailed economic analysis of the business enterprise. They question whether those distinctions should reflect different product lines, different job duties, or disparate skill levels and how such distinctions could be developed and administered in an objective fashion. Other problems would arise in developing a geographic locale rule. Determining the situs of an employee could be complicated, as would dividing an employer with operations throughout a region.

In addition, some suggest that it may be difficult to coordinate line of business or geographic locale rules with nondiscrimination requirements. They note that Congress originally applied the controlled group rules to prevent an employer from avoiding the nondiscrimination rules by operating through separate corporations instead of separate divisions. New distinctions based on job duties, they argue, might permit distinctions based on management duties, thereby permitting an employer to cover management personnel without covering rank-and-file employees, which was one of the perceived abuses that Congress specifically addressed and tried to prevent in ERISA.[16] Similarly, distinctions based on geographic locale might permit an employer to provide benefits for home office employees who are often highly compensated without covering lower-paid employees of operating companies. Also, these new distinctions might result in the exclusion of assembly-line workers who are creating one product, while other assembly-line workers with similar job functions would be covered if they were creating a "different" product or working in a different geographic locale.

Some benefit experts assert that the line of business approach, which was recently applied to certain statutory fringe benefits, has already proven difficult to administer with respect to employee discounts. For example, some are concerned that, for fringe benefit purposes, employees of organizations providing catering services, hotel accommodations, or rental cars as an adjunct to air travel, may be considered separate lines of business. Historically, fringe benefits have been available to all such employees as though employed in a single line of business. However, because it may be difficult to demonstrate that pension benefits provided to catering employees or hotel personnel are "comparable" to those afforded pilots and flight attendants, some claim that each of those functions represents a different line of business for pension purposes. Some suggest that it is inappropriate to develop two different and opposite standards—one for fringe benefits and the other for pension benefits.

Nevertheless, because some are sensitive to the assertion that a conglomerate business entity needs flexibility to provide different benefits for bona fide separate operations (especially in the case of new acquisitions), it has been suggested that other exceptions to the Administration's proposed coverage test might be developed. However, because pension benefits are based upon compensation and compensation is already adjusted to reflect lines of business

[16] See H. Rpt. 93-807, 93rd Cong., 2d Sess. 50 (1974); S. Rpt. 93-383, 93rd Cong., 1st Sess. 43 (1973).

and geographic locale, others argue that no further adjustment in the coverage test is needed.

On the other hand, some argue that the variations noted in different lines of business or geographic locales are caused not only by fluctuations in the total amount of compensation but also by variations in the mix of current and deferred compensation. They believe that it is unnecessary to impose artificial restraints on the relative allocation of current and deferred compensation through expanded coverage rules. Thus, they believe further adjustments are appropriate to reflect these problems.

Others question whether it is appropriate to permit unlimited flexibility to tailor different compensation packages for different employees within a controlled group. They believe that it is inappropriate to encourage the provision of inadequate benefits for employees in certain industries. Some argue that, consistent with the tax policy goal of permitting tax benefits only to those plans that provide benefits for low- and middle-income employees, the coverage rules should preclude the provision of lower benefits for certain employees based on their line of business or geographic locale. They further point out that some employers that acquire additional subsidiaries or lines of businesses require the newly acquired entities to adopt the employer's plan within a certain period of time. This, they argue, undermines the argument that business reasons, rather than corporate custom, underlie the decisions by other employers not to have a uniform plan throughout their controlled group.

Excludable employees

Proponents of the Administration proposal argue that it is appropriate to narrow the class of excluded employees. In determining whether a plan covers a significant percentage of employees, they argue that, in situations other than those involving legitimate collective bargaining agreements or nonresident aliens, it is appropriate to consider at least those employees who have attained age 21 and completed one year of service. In applying the exclusion for collective bargaining, however, some argue that it is inappropriate to exclude employees merely because the employer has negotiated in some fashion with a tax-exempt labor organization. They emphasize the importance of ensuring that retirement benefits were the subject of good faith collective bargaining.

In addition, some argue that it is also appropriate to require coverage of those employees who work on a part-time or seasonal basis. They believe that such employees also have retirement needs and expectations.

Opponents of the proposals argue that the participation rules permit an employee to be excluded from participation for up to three years provided they are fully vested upon entry. Arguably, the delay in the time at which participation must commence is offset by the accelerated vesting. If it is acceptable to exclude an employee for up to three years for participation purposes, they question why such an employee should be included in applying the coverage rules.

Proponents of the Administration proposal argue that, when ERISA permitted a plan to exclude an employee from participation for up to three years, the provision was designed, in part, to encourage accelerated vesting and to permit a participation option complying with the then applicable rules relating to plans of self-employed individuals (H.R. 10 plans). Those rules, which were originally designed to enhance benefits for rank-and-file employees, also permitted an employee to be excluded for up to three years, provided the employee's benefits were fully vested when the employee was covered. Full vesting after three years is much faster than vesting under the other ERISA schedules. With the enactment of the cash or deferred rules (which require that an employee be immediately fully vested in elective deferrals) and the top-heavy rules (requiring either three-year cliff vesting or a six-year graded vesting) they argue that many plans are now required to provide accelerated vesting. Accordingly, they support the proposal to repeal the participation provision permitting exclusion for up to three years.

Tax-sheltered annuities

Some have suggested that tax-sheltered annuity programs should be required to meet the new coverage tests proposed for qualified plans. They question why these programs should be permitted to cover small numbers of employees, which may include only those who are relatively highly compensated (e.g., teachers or professors).

Opponents argue that tax-sheltered annuities were originally designed to meet the special needs of educational organizations, churches, and other tax-exempt organizations. Since 1942, these programs have been the primary retirement plan for most educational organizations and churches. They argue that it is inappropriate after 43 years to disrupt these programs, thereby undermining the expectations of sponsoring employers and covered employees.

In addition, many assert that, at least with respect to educational institutions, there is broad, nondiscriminatory coverage of other employees, including administrative employees. Though teachers or professors may be the only employees eligible to receive tax-sheltered annuities, this group suggests that other employees receive equivalent benefits through other retirement programs.

Proponents of the proposal question the accuracy of these assertions. They point out that existing data demonstrate the extent of coverage, but do not provide useful information regarding the level of promised benefits, the extent to which those promised benefits are integrated with social security, or the extent to which such benefits are subject to deferred vesting. They argue that if benefits provided to nonteaching staff are "comparable," those plans will not be adversely affected by the proposal to require nondiscriminatory coverage.

Others point out, however, that determinations of "comparability" are extremely complicated, and thus are costly to administer. They question why it is appropriate to require tax-exempt employers, whose funds should theoretically be used to further their exempt purpose, to spend those funds to employ actuaries, lawyers, and accountants to demonstrate comparability.

Opponents of the proposal also believe that the flexibility afforded by tax-sheltered annuities is particularly appropriate to the needs of educational organizations. They argue that, in the case of colleges and universities, mobile or visiting professors are needed to enlarge and update the scope of college courses to stimulate both students and tenured faculty. Securing a visiting professor would be difficult if that professor's retirement benefit were reduced because of the temporary assignment. Tax-sheltered annuity programs, they argue, meet this need because they are flexible, portable, and provide fully vested benefits. These needs, however, may be very different from the long-term benefit security issues faced by clerical or administrative staff. Thus, they argue, that educational institutions need the flexibility to respond to each group by providing different types of plans for faculty and service personnel.

Proponents of the proposal question whether it is appropriate to provide better benefits for a short-term or visiting professor than a career clerical employee. They note that flexibility still could be afforded through the use of different plans, but that it is important to ensure that those "different" plans provide comparable benefits.

Some also point out that an educational institution is forced to compete on a national job market for professors, while staff recruiting is primarily local. They argue that the need to compete in a national job market may require that they provide a certain level of benefits to attract professors. If that level of benefits also was required for staff, they argue, they often would become the highest cost local employer, regardless of whether a decision to provide that level of benefits was appropriate in a business sense.

Others argue that it may be appropriate to distinguish among various tax-exempt entities. For example, flexibility afforded to churches or educational organizations may not be appropriate for private foundations. This group argues that coverage requirements should at least be imposed on plans maintained by private foundations or, alternatively, that such foundations be precluded from sponsoring tax-sheltered annuity programs.

2. Benefits and Contributions

Present Law and Background

In general

The Code provides nondiscrimination standards for qualified plans. These standards prohibit discrimination in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees) (sec. 410(b)). Under these standards, 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 (sec. 401(a)(4)).

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."[17]

Congress was concerned that the requirement of nondiscriminatory coverage by a plan was not sufficient. Although nondiscrim-

[17] H. Rpt. 77-233, 77th Cong., 2d Sess. 51 (1942).

inatory 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."[18]

The present-law discrimination requirements are satisfied if either the contributions or the benefits under a qualified plan do not discriminate in favor of employees who are officers, shareholders, or highly compensated (sec. 401(a)(4)).

Defined contribution plans

A defined contribution plan is required to allocate employer contributions, earnings, and forfeitures pursuant to a definite allocation formula. Contributions under the plan must not discriminate, in form or in operation, in favor of highly compensated employees.

Present law requires that a participant vest in employer-derived accrued benefits at least as rapidly as under one of three statutory schedules. In the case of a defined benefit pension plan, present law requires ratable increases in an employee's accrued benefit based on the employee's completion of years of participation.[19] These accrual rules do not apply to defined contribution plans. In a defined contribution plan, a participant's accrued benefit is the balance of the participant's account. However, some defined contribution plans take years of service into account in the formula used to allocate employer contributions.

Aggregation of plans

Since 1942, an employer has been permitted to designate two or more plans as a single plan for purposes of satisfying the coverage requirements.[20] However, if several plans are designated as a single plan, the plans, considered as a unit, must be provided for the exclusive benefit of employees and also must provide contributions or benefits that do not discriminate in favor of employees who are officers, shareholders, or highly compensated (highly compensated employees).

A plan is not maintained for the exclusive benefit of employees if, by any device, it discriminates either in eligibility requirements, contributions, or benefits in favor of employees who are officers, shareholders, or highly compensated. Some variations in benefits or other plan options may be permitted provided the plan, as a whole, does not discriminate in favor of highly compensated employees and the availability of any particular option is not so restricted that it is, in effect, available only to members of the highly compensated group.

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[18] Ibid.

[19] See the discussion of accrued benefits under Top Heavy Plans, Part III. C., below.

[20] Section 1.410(b)-1(d)(3)(ii) of the income tax regulations prohibits this designation in certain cases involving TRASOPs and, prior to 1984, plans subject to section 401(a)(17).

Comparability

In general.—In determining whether several different plans designated as a unit provide benefits or contributions that do not discriminate in favor of highly compensated employees, it is necessary to determine whether the different plans provide "comparable" benefits or contributions. Historically, benefits were compared in the case of defined benefit pension plans and contributions were compared in the case of defined contribution plans. If both types of plans were aggregated, either benefits or contributions were compared.

Revenue Ruling 81-202 [21] provides guidance that may be applied to determine whether the amount of employer-derived benefits or contributions provided under several plans discriminate in favor of highly compensated employees. That ruling provides (1) methods to adjust all types of benefits to a standard form; (2) methods to convert benefits into contributions, and contributions into benefits; and (3) methods for imputing the value of employer-provided social security benefits. (For a more complete discussion of social security integration, see Part III. A. 3.)

The ruling generally provides that the amount of employer-derived benefits provided by a plan or plans will be considered nondiscriminatory if (1) the Normalized Employer-Provided Benefits, or (2) both the Actual Employer Contributions and the Adjusted Contributions, do not constitute a greater percentage of nondeferred compensation for any highly compensated employee than for any nonhighly compensated employee. The ruling allows either contributions or benefits to be compared regardless of the type of plans involved.

Comparability of benefits.—Under Revenue Ruling 81-202, if comparability is to be tested on the basis of benefits, the Normalized Employer-Provided Benefit[22] provided for any highly compensated employee must not constitute a greater percentage of nondeferred compensation than for any nonhighly compensated employee.

Comparability of contributions.—Under Revenue Ruling 81-202, if comparability is to be determined on the basis of contributions, neither Actual Employer Contributions nor Adjusted Employer Contributions[23] for any highly compensated employee may constitute a greater percentage of nondeferred compensation than for any nonhighly compensated employee.

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[21] 1981-2 C.B. 93.

[22] The Normalized Employer-Provided Benefit for any individual is the employer-provided portion of the most valuable projected benefit, expressed as the actuarial equivalent amount of plan benefit commencing at age 65, and adjusted to reflect (1) the value of an annuity for the life of the participant commencing at such age with no death benefits and no other ancillary benefits as well as (2) the difference, if any, in vesting provisions among the plans being considered.

[23] In a defined contribution plan, Actual Employer Contributions are the employer contributions allocated to a participant's account, determined without taking forfeitures into account and Adjusted Employer Contributions are the sum of employer contributions and forfeitures projected to be allocated to a participant's account during the period of participation. In the case of a defined benefit pension plan, Actual Employer Contributions and Adjusted Employer Contributions for any participant are identical—the amount needed to fund the Normalized Employer Provided Benefit over the participant's period of participation (i.e., from the date of initial participation to the latest of age 65, current age or normal retirement age). In making this calculation, the only actuarial assumptions to be used are reasonable interest and mortality assumptions.

Social Security integration.—Revenue Ruling 81-202 also includes rules to value employer-provided social security benefits in testing comparability. The value of those social security benefits may be taken into account whether or not the plans are explicitly coordinated with social security.

Disparity in other plan provisions.—Revenue Ruling 81-202 measures only whether the amount of employer-provided benefits or contributions are discriminatory. A plan that provides comparable benefits, within the meaning of that ruling, could still be considered discriminatory if other plan provisions, in form or operation, discriminate in favor of highly compensated employees. For example, a plan which permitted only highly compensated employees to elect to receive a lump sum distribution was determined to be discriminatory in Revenue Ruling 85-59.[24]

Limit on includible compensation

Congress has, in some circumstances, limited the extent to which highly compensated employees can benefit under a qualified plan by restricting the amount of compensation that is taken into account in computing benefits. One such restriction was intended to prevent an inappropriate allocation of benefits or contributions, as a percentage of pay, away from lower-paid employees under plans also covering an owner with very high levels of compensation.[25]

From 1974 through 1981, only the first $100,000 of compensation could be taken into account under an H.R. 10 plan, a plan of a subchapter S corporation, or a Simplified Employee Pension (SEP) (sec. 401(a)(17), as in effect prior to 1982). Because includible compensation was limited to $100,000, no self-employed individual with income greater than $100,000 could receive the maximum permitted contribution of $7,500, unless a contribution of at least seven and one half percent of compensation were provided to other employees.

Effective for years beginning after 1981, the Economic Recovery Tax Act of 1981, (ERTA) increased the maximum amount of compensation that may be taken into account under an H.R. 10, or subchapter S corporation plan, or a SEP, from $100,000 to $200,000. However, to prevent a plan that elected to consider compensation in excess of $100,000 from reducing contributions or benefits that would otherwise have been required for common-law employees, ERTA prescribed minimum contribution or benefit levels.[26]

Effective for years beginning after 1983, the Tax Equity and Fiscal Responsibility Tax Act of 1982 (TEFRA) made the $200,000 limit on includible compensation applicable only to plans that are top heavy (sec. 416(d)) and to SEPs.

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[24] 1985-19 I.R.B. 4.

[25] H. Rpt. 93-807, 93rd Cong., 2d Sess., 113 (1974), S. Rpt. 93-383, 93rd Cong., 2d Sess. 121 (1973).

[26] In a defined contribution plan or a simplified employee pension (SEP) that considers compensation exceeding $100,000, an employer was required to make contributions on behalf of a common-law employee (in a SEP, any employee) at a rate not less than 7.5 percent of the employee's compensation.In a defined benefit pension plan that takes compensation in excess of $100,000 into account, an employer was required to provide an annual benefit accrual for each common-law employee who has attained a particular age at least equal to a percentage of compensation that was one-half of the maximum annual benefit accrual permitted under a defined benefit H.R. 10 plan for a self-employed individual who has attained that age.

Administration Proposal

No proposal.

Possible Proposals

Definition of highly compensated employee

It has been suggested that the definition of highly compensated employee used for testing nondiscrimination in benefits be conformed with the definition proposed by the Administration for testing coverage and elective deferrals under cash or deferred arrangements.

Includible compensation

It has been suggested that the limit on includible compensation should be reduced and extended to all plans. For example, it could be provided that no plan could take compensation in excess of $120,000 into account.

Defined contribution plans

Some have suggested that it is appropriate to preclude or restrict the use of service-weighted allocation formulas in defined contribution plans.

Concentration test

It has also been suggested that it is appropriate to adopt a concentration test to limit the proportion of benefits that can go to certain highly compensated employees of a business. For example, benefits provided for the top 20 highly compensated employees could be limited to 25 percent of total benefits.

Aggregation of plans

It has been suggested that it is inappropriate to permit one employer to maintain multiple plans, each covering a very small number of employees. Some have proposed that a qualified plan should be required to benefit the lesser of a specified number of employees (e.g., 50) or all employees, other than those excluded by reason of age, service, collective bargaining agreements, etc.

Some have suggested that the application of comparability rules should be limited by reducing the extent to which separate plans can be maintained and by requiring that all plan features, including, for example, disparate funding levels and benefit options, be taken into account in testing comparability.

Discriminatory funding

It also is proposed that, in the case of a defined benefit pension plan that meets the qualification requirements of the Code only because it is considered to be comparable with another defined benefit pension plan, disparity in funding levels should be discouraged by disallowing a deduction for a contribution to that plan if it is better funded than the plan on which it depends.

Tax-sheltered annuities

Some have proposed that it is appropriate to require that tax-sheltered annuities provide nondiscriminatory benefits.

Analysis

Definition of highly compensated employee

Those in favor of making the proposed definition of highly compensated employee apply for purposes of testing discrimination in benefits argue that it is inappropriate to identify one group, for purposes of testing discriminatory coverage while identifying a different, possibly overlapping group, for purposes of testing discriminatory benefits. They argue that the present-law definition is subjective, imprecise, and difficult to administer. (For a more complete discussion of this issue, see Part III.A.1., Coverage.)

Includible compensation

Proponents of the proposal to limit compensation that may be taken into account argue that it is important to ensure adequate benefit levels for nonhighly compensated employees. Consistent with that goal, some question whether it is appropriate to permit benefits to vary based on compensation. They argue that compensation-related variations necessarily discriminate in favor of highly compensated employees. If, however, some variation is permitted to reflect different lifestyles, they argue that it is inappropriate not to cap the includible compensation because lifestyles based on compensation above, for example, $120,000 should not be subsidized by the government. Moreover, if variation by compensation is permitted, it is necessary to limit the resultant discrimination by capping the compensation taken into account.

Just as social security has a limit ($39,600 for 1985) on the amount of salary covered, some argue that there is a reason to have a limit on the maximum salary taken into account under qualified plans. They believe that compensation in excess of the limit should not be permitted to reduce the level of contributions provided to other employees. If includible compensation is capped at $120,000, and any individual receives allocations equal to the dollar limit under a nonintegrated plan, all other employees would receive a 25-percent of compensation allocation. If compensation were not capped, and an individual earning $200,000 received the maximum dollar allocation ($30,000), other employees generally would receive only a 15-percent allocation.

Some of those favoring a limit on includible compensation argue, that the level of the cap must be coordinated with the separate plan limits on contributions and benefits. If, for example, Congress determines the appropriate limit on annual additions to be the lesser of 25 percent of compensation or $30,000, they argue that at least $120,000 of compensation should be taken into account. Alternatively, if Congress determines that a lower cap should be imposed on includible compensation, the percentage or dollar limits could be appropriately adjusted to limit discrimination.

Opponents of the proposal argue that, although it may be appropriate to require that contributions or benefits be a uniform percentage of compensation, it is inappropriate to limit includible compensation. They argue, for example, that if $30,000 is the appropriate dollar limit on contributions to a defined contribution plan, it should be possible to provide up to $30,000 for highly compensated employees, expressed as a percentage of compensation if the employer provides uniform percentage contributions for all employees. They argue that a proposal to limit includible compensation to $120,000, for example, is, in effect, an indirect attack on the $30,000 limit because 25-percent contributions are unreasonably high and no plan would provide contributions at that level.

Defined contribution plans

Those favoring the proposal to preclude service weighted allocation formulas in defined contribution plans argue that it is inappropriate to use a years-of-service factor in determining a participant's share of plan contributions. They believe that service weighting actually serves to "backload" a participant's benefit accrual by providing relatively low levels of allocations in early years and disproportionately high allocations during final years of employment.

In 1974, during the consideration of ERISA, Congress expressed concern about backloading devices. At that time, Congress concluded that it was ". . . obviously necessary to put some limits on this device; otherwise a plan that wishes to evade the vesting requirements could provide for de minimis accruals until an employee's last years of employment at which point very large accruals would be provided . . .".[27] ERISA precluded backloading in defined benefit pension plans by requiring that a participant accrue benefits ratably during periods of participation.

Those favoring the proposal believe it is equally important to limit backloading in defined contribution plans by disregarding length of service, especially because most long service employees are highly compensated vis-a-vis short term employees.

Opponents argue that service weighted allocation formulas are an appropriate incentive to older employees. They believe that service weighting should not be considered discriminatory because often it operates to increase allocations to low-paid, long-service employees. They argue that service weighted allocations are often designed to provide nondiscriminatory target benefits upon retirement. Others suggest, however, that if service weighted formulas are designed to enhance retirement benefits, they should be permitted only in those defined contribution plans that restrict preretirement distributions.

Concentration test

Some argue that it is appropriate to limit the aggregate amount of plan benefits provided to highly compensated employees. They point out that, under present law, various concentration tests apply to limit benefits in cafeteria plans, group legal services plans, educational assistance plans, and dependent care assistance programs. In addition, the Administration proposal would apply a uniform

[27] See H. Rpt. 93-807, 93rd Cong., 2d Sess. p. 60 (1974).

concentration test to all excludable fringe benefits. Those favoring the concentration test argue that it should be applied to pension benefits as well.

Opponents of the proposal argue that no concentration tests are needed for qualified plans because plans that provide benefits primarily to highly compensated employees (top-heavy plans) are already subject to more restrictive qualification rules. They argue that, because those rules require, in part, that all non-key employees receive minimum, nonintegrated benefits or contributions, no concentration tests are needed.

Those favoring the imposition of a concentration test argue that qualified plans receive tax benefits to encourage employees to provide benefits for low- and middle-income employees. Consistent with this goal, they suggest that the concentration test would be more effective in limiting discrimination. They point out that the suggested concentration test generally applies a much lower limit on benefits that may be provided to key employees. The Administration proposal, for example, would limit fringe benefits payable to the top-20 highly compensated individuals to 25 percent of total benefits, while the top-heavy rules apply to plans that provide more than 60 percent (90 percent, in the case of super top-heavy plans) to a group of key employees that may be more expansive than the top 20. In addition, they suggest that the top-heavy rules do not limit benefits that may be provided to key employees; they merely require that certain minimum benefits be provided to non-key employees. In some instances, there may be few or none of those non-key employees. Those supporting a concentration test believe it is more appropriate to limit the benefits payable to certain highly compensated employees, thereby ensuring the delivery of greater benefits to low- or middle-income employees.

Comparability

In general

Those favoring a proposal to limit the extent to which plans may be considered as a single plan for purposes of testing compliance with the coverage and nondiscrimination rules argue that the present-law rules do not ensure the delivery of nondiscriminatory benefits. They believe the present-law rules to be inadequate because (1) the factors used to determine equivalence overstate the value of ancillary benefits, (2) the actual benefits provided often do not reflect promised ancillary benefits, (3) the test assumes continuation of the plan until each participant earns the projected benefit while, in reality, many plans terminate earlier, (4) the rules do not take disparate funding levels into account, and (5) they do not precisely limit the extent to which disparate options are permitted.

For example, the tests defined in Revenue Ruling 81-202 permit an employer to project the benefits a participant would earn assuming the participant remained until normal retirement age, and that the plan remained in effect for that period. If the amount of projected benefits is nondiscriminatory, the plans satisfy the nondiscrimination rules.

In some situations, for example, an employer may maintain two plans—one benefiting highly compensated employees and one benefiting rank-and-file employees. Often, the plans exist only for that period necessary to allow the highly compensated employees to earn the maximum benefits. Upon termination, the plan benefiting highly compensated employees generally is fully funded and those employees have accrued the maximum benefit. Frequently, the plan is so well funded that a surplus reverts to the employer upon plan termination, and, in some instances, that surplus (created in whole or in part by tax-free growth), is applied to provide additional nonqualified deferred compensation benefits for highly compensated employees. At the same time, rank-and-file participants generally have not fully accrued their benefits and, often, their plan has not fully funded those benefits that were accrued. Some argue that this result is inappropriate and that no employer should be permitted to provide such discriminatory benefits through the use of multiple plans.

Some argue that the difficulty of comparing all plan features leads one to the conclusion that employers should be precluded from maintaining multiple plans. It has been suggested, for example, that plans should be required to cover the lesser of 50 employees or all employees not excluded by reason of age, service, etc. Because multiple plans are often used to provide flexibility only for highly compensated employees, some believe that this rule will not operate to disadvantage rank-and-file employees.

Others argue that it is inappropriate to preclude an employer's ability to aggregate several plans. They believe that different retirement arrangements may be needed to reflect the needs of different employee groups. They believe, for example, that younger, more mobile workers may prefer to participate in a defined contribution plan while older, long-service workers may prefer a defined benefit pension plan. If an employer is precluded from aggregating several plans, it may be necessary to cover all employees under a single plan that does not best suit their retirement needs. On the other hand, an employer could provide both a defined benefit and a defined contribution plan for all employees which would provide all employees with the benefit of both types of plans. This approach also addresses the problem that it is primarily the wishes of the highly paid which are reflected in current plan design.

Discriminatory funding

Proponents of the proposal to limit deductions for employer contributions under certain defined benefit pension plans believe that it is appropriate to consider funding levels in determining whether plans are comparable. Even if the amount of benefits under a plan for highly compensated employees is comparable to the amount of benefits provided for rank-and-file employees under another plan, the plan for highly compensated employees should not be considered nondiscriminatory if the benefits of the highly compensated employees are more secure because of better funding. If there is disparity in the level of funding, some argue that the better funded plan should be disqualified. Others believe, however, that disqualification of the plan for highly compensated employees under these circumstances would be an inappropriate sanction because the discrimination could be cured by improving the funding levels under the plan for rank-and-file employees. They argue that denying deductions for contributions to the plan for highly compensated employees until the rank-and-file plan is comparably funded is a more appropriate sanction because it more accurately measures the extent and duration of the discrimination.

Proponents argue that the proposal would also tend to reduce the risk of the Pension Benefit Guaranty Corporation (PBGC). They point to the possibility that an employer will maintain a fully funded plan for its executives and an underfunded plan for its rank-and-file employees. If the employer terminates the plans at a time when the rank-and-file employees plan does not have enough assets to provide benefits guaranteed by the PBGC, the PBGC is required to pay benefits under such a rank-and-file plan without being able to recoup its losses from the better-funded executive plan.

On the other hand, those who oppose the proposal argue that it would add further complexity and uncertainty to the rules for funding qualified defined benefit pension plans. They question whether it is appropriate to use deduction limits as a sanction for qualification problems.

In addition, they argue that, in general, the benefits of rank-and-file employees under these plans are fully guaranteed by the PBGC. If the guarantee is taken into account, those benefits are as well secured as benefits under a plan for highly compensated employees. Some also argue that a plan should not be considered to be underfunded if the rate of its funding meets the minimum funding standard.

Others argue that disparities in the level of funding may be caused by different investment programs rather than discriminatory funding patterns. They believe that employer deductions should not be limited merely because one plan has undertaken a more aggressive investment program than another plan and that program has resulted in superior investment performance.

3. Integration

Present Law and Background

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."[28]

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

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."[29] 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.[30] 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.

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 similar test may be applied to employer contributions under a plan. 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.[31]

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[29] Ibid.

[30] See, e.g., S. Rpt. 1631, 77th Cong., 2d. Sess. 139 (1942).

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

(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 which (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 83-1/3 percent of the annualized primary insurance amount (PIA) to which an employee is entitled under the Social Security Act. This calculation forms the basis of the present-law rules for integrating offset plans. 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 83-1/3 percent of the employee's PIA. These rules have not been changed since 1971 even though the Social Security Act has been amended several times.

(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 designed 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.

The Internal Revenue Service determined that the employer-provided portion of benefits under social security averages 37-1/2 percent of the average maximum pay on which social security benefits are based. This calculation forms the basis of the present-law rules for integrating excess plans. 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 37-1/2 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 $13,800 of pay. These rules have not been changed since 1971 even though the Social Security Act has since been amended several times.

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 37-1/2 percent. For example, an integrated excess plan could provide benefits at the rate of 12-1/2 percent for all compensation plus 50 percent (i.e., 37-1/2 percent plus 12-1/2 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).[32] 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

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

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).

Administration Proposal

No provision.

Other Proposals

S. 1169 (Durenberger) and H.R. 2622 (Kennelly)

S. 1169 and H.R. 2622 would extend minimum benefit requirements to certain nontop-heavy plans. Under the proposal, any qualified plan that is integrated with social security would be required to provide a minimum nonintegrated benefit or contribution derived from employer contributions for each participant.

A defined benefit pension plan would satisfy this minimum benefit requirement if, on a cumulative basis, the accrued benefit of each participant, when expressed as an annual retirement benefit, is not less than one and one-half 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 would not be required to exceed 15 percent of such average annual compensation. The required minimum benefit for an employee could 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 integrated, the employer generally would be required to contribute on behalf of each plan participant for the year an amount not less than two and one-half percent of the participant's compensation. The minimum contribution would be required for each year in which the plan is integrated.

A special rule provides that if the employer's contribution rate for each participant is less than two and one-half percent of compensation, the required minimum contribution rate for each employee generally would be limited to not more than the highest contribution rate for any participant.

Amounts paid by the employer for the year to provide social security benefits for the employee would be disregarded. Thus, the required minimum contribution for a non-key employee could 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).

Under the bills, any top-heavy plan (whether or not integrated with social security) would remain subject to the top-heavy minimum benefit requirements.

The bills would not prohibit the integration of benefits or contributions in excess of the minimum benefits or contributions.

Excess plans

Some have suggested that it is inappropriate to permit integration through use of a pure excess plan approach.

Limited integration

Others have proposed that the degree of integration under a plan should vary directly with promised plan benefits. For example, under a defined benefit pension plan that is an offset plan, the percentage of the social security primary insurance amount (PIA) that a plan could apply as an offset against the regular pension benefit could be limited to the percentage of average pay replaced by the regular benefit. For example, if a plan provided a regular annual benefit of 60 percent of an employee's average pay, the offset could not exceed 60 percent of the PIA.

Similarly, under a defined benefit pension plan that was an excess plan, the benefit provided with respect to average pay in excess of the integration level specified in the plan could be limited to an amount not greater than specified multiple of the rate at which the plan provides benefits for average pay below the integration level.

Under a defined contribution plan, the rate of employer contributions with respect to annual pay in excess of a plan's integration level could be limited to an amount not greater than a multiple of the rate of employer contributions with respect to annual pay below the integration level.

Repeal of integration

Some have suggested that qualified plans should not be allowed to take social security benefits or contributions into account in determining whether the plan discriminates in benefits or contributions.

Analysis

In general

Those in favor of reducing or eliminating integration argue that the existing rules are inconsistent with the tax policy goals encouraging the delivery of nondiscriminatory benefits. They question why any tax benefits should be provided for a plan that does not provide adequate benefits for lower-paid employees.

They further contend that social security benefits do not provide an adequate replacement of preretirement earnings for low- or middle-income workers. Because social security may provide inadequate benefits, the Code provides tax incentives to encourage employers to provide additional retirement benefits. Therefore, they argue that integration, which permits the employer to reduce or eliminate qualified plan benefits for lower-paid employees, undermines the original Congressional policy for providing the tax incentives. Accordingly, it is suggested, the Code permits qualified plans to provide adequate levels of benefits for highly compensated employees without requiring that benefits be provided at adequate levels for other employees.

Some argue further that integration is inconsistent with the policy foundations of the social security system. If, under social security, it was considered appropriate to take into account only a limited amount of compensation ($39,000 for 1985), they believe this position is undermined by permitting qualified plans that provide benefits on greater amounts of compensation to integrate plan benefits with social security benefits. Those who favor repealing integration also point out that repeal would eliminate a substantial source of complexity in the qualified plan area.

Some believe that, even if a proper integration system has a legitimate place in the design of private retirement systems, it is necessary to review the extent to which it should be permitted. It is suggested that the existing integration rules are outdated and no longer reflect the underlying social security system or the retirement needs of the present workforce.

Others argue that the focus of tax policy should be to encourage adequate post-retirement replacement rates for all retirees. In testing the adequacy of retirement income, it may be appropriate to take social security benefits into account—but only at the point when an employer-provided pension benefit, when added to social security benefits, reaches a stipulated level of adequacy. Some argue that, at least for lower-paid workers, full replacement of preretirement earnings is the appropriate goal and, therefore, that qualified plans should fill the gap between social security and full replacement. They would permit social security benefits to be taken into account in determining full replacement and would permit plans to provide increased benefits for higher compensated employees. For example, a qualified plan which, standing alone, provides greater benefits to higher paid employees could be considered nondiscriminatory if the plan, together with social security, provides full wage replacement and the combined benefit does not favor highly compensated employees.

Others suggest that it is more appropriate to address the issue of benefit delivery in a manner similar to the top-heavy plan rules by requiring that all qualified plans provide some minimum level of nonintegrated benefit. They argue that this would preclude the necessity of developing complicated new rules for integrating social security and plan benefits, while still ensuring an adequate replacement ratio. Under this approach, existing plan formulas for integration would continue, subject to the requirement of a floor (i.e., a minimum nonintegrated benefit that must be provided to all participants).

Those supporting the present-law concept of social security integration argue that the employer's contribution to retirement income consists of two elements—social security benefits and qualified plan benefits. To the extent the employer contributes to the provision of both types of benefits, they argue, it is appropriate to test for nondiscrimination on a combined basis. They believe that, because social security benefits, expressed as a percentage of compensation, are weighted in favor of lower-paid employees, it is appropriate to provide qualified plan benefits weighted in favor of higher-paid employees provided that benefits in the aggregate constitute a uniform percentage of compensation.

Excess plans

Proponents of the proposal to repeal the excess plan integration rules argue that it is inappropriate to permit qualified plans to completely exclude lower-paid workers. They argue that tax benefits are provided to qualified plans because social security alone does not provide full replacement for lower-paid workers, and question why any benefits should be provided for plans that do not benefit those lower-paid workers. They point out that the present-law rules for integrating through use of an excess plan permit an employer to provide contributions, for example, only for those who earn in excess of $39,600 per year. They argue that it is more appropriate to require that all plans provide benefits on the first dollar of salary.

Opponents of the proposal argue that benefits that are uniform, as a percentage of pay, should be permitted whether those benefits are paid from social security or a qualified plan. Accordingly, they argue that excess plans should be permitted provided the sum of the employer social security contributions plus plan contributions constitute a uniform percentage of pay for all employees.

B. Vesting

Present Law and Background

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.

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, ERISA and the Code generally require: (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, preretirement vesting was sometimes required under a qualified plan to prevent discrimination. Although ERISA required all qualified plans to meet certain minimum preretirement vesting standards, ERISA also provided that earlier 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 earlier preretirement vesting for certain top-heavy plans to improve the likelihood that covered participants would receive benefits.[33] 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 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 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.

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

Administration Proposal

No proposal.

Other Proposal

S. 1169 (Durenberger) and H.R. 2622 (Kennelly)

The Economic Equity Act of 1985 (S. 1169 and H.R. 2622) would further accelerate preretirement vesting in employer-derived accrued benefits. The bill would repeal the statutory vesting schedules of existing law, and generally require any qualified plan to provide that a participant's right to employer-derived benefits become fully vested upon completion of five years of service (no vesting would be required before the end of the fifth year). Special rules would require certain multiemployer plans to provide that a participant's rights to employer-derived accrued benefits be fully vested upon completion of 10 years of service. As under present law, top-heavy plans would be required to satisfy the special top-heavy vesting requirements.

In addition, the bill would repeal class year vesting, and require that a class year plan meet the new five-year schedule (or, if appropriate, one of the top-heavy schedules).

Analysis

Proponents of more rapid vesting stress that present law does not meet the needs of many workers who change jobs frequently. They point out that, in many industries, employers and employees understand that jobs will be of limited duration. They argue that, although women and minorities are disadvantaged by the present rules because they tend to be more mobile, shorter service employees, deferred vesting also deprives men of pension benefits. They also point out that lower-paid employees also are more likely to be mobile, and thus more likely to terminate employment before vesting in any accrued benefits. Accordingly, they believe that more rapid vesting would enhance the retirement income security of low- and middle-income employees.

In addition, those arguing for more rapid preretirement vesting argue that qualified plan benefits are provided to employees in lieu of current compensation. Thus, they question the extent to which an employee who (directly or indirectly) accepts a reduced current compensation package in exchange for qualified plan benefits should have his receipt of plan benefits made contingent on any deferred vesting schedule. They point out that, if an employee directly elects to reduce current compensation by making salary reduction contributions (elective deferrals) to a qualified cash or deferred arrangement (sec. 401(k)), that employee's benefits derived from elective deferrals must be fully vested at all times. Because most employers take both current and deferred compensation costs into account in establishing or revising current compensation levels, some argue that all employer contributions to qualified plans are, in effect, an indirect form of salary reduction. Conceptually, if employer contributions to qualified retirement plans are really deferred compensation, they should be fully vested as soon as the services required to earn the benefits are complete.

Those favoring some deferral of vesting argue that it is inappropriate to provide any deferred compensation benefits to short-service, part-time, or transient workers—both because of the cost of providing benefits to those employees and because they regard pension benefits as a reward for worker loyalty and productivity. They argue that deferred vesting is appropriate to preclude the provision of benefits to these transient employees, thereby allowing them to provide better or larger benefits for the more stable, longer-term workforce. On the other hand, some argue that the tax incentives were designed to enhance retirement income security generally, not just the retirement income provided for long-term employees.

If deferred vesting is found to be appropriate, it may be necessary to determine what period and what type of deferral should be permitted and whether different minimum schedules should be permitted in different industries. Proponents of accelerated vesting argue that it is inappropriate to fully vest an employee only after completion of 10 or 15 years of service, particularly in view of current working patterns. They also question whether "cliff" vesting (no vesting until the end of the stipulated period) should be permitted or whether all vesting should be "graded" (i.e., ratable based on periods of service).

Proponents of faster vesting also note that vesting by itself will not ensure retirement security. Distribution of the vested benefits must be deferred until retirement age to preclude preretirement consumption of vested benefits. They argue that earlier distributions should be prohibited or at least discouraged through the imposition of a penalty tax on early distributions. For a more complete discussion of the distribution issues, see Part IV, below.

C. Top-Heavy Plans

Present Law and Background

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 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 (sec. 416).

Top-heavy calculation

A defined benefit pension 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 33-1/3 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 "133-1/3-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 133-1/3 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.

However, these accrual rules are not applicable to the minimum benefits required under a top-heavy plan. A top-heavy defined benefit plan generally must provide that each participant's minimum benefit is, on a cumulative basis, at least equal to two percent of compensation for each year of service during which the plan is top heavy, not to exceed 20 percent (sec. 416(c)).

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 required minimum benefit is determined without application of the scheduled accrual rules. Thus, for example, a non-key employee with one year of participation for a plan year during which the plan is top heavy, is entitled to a minimum benefit of two percent of compensation, not a fraction of that two percent determined through application of the plan's accrual schedule.

Administration Proposal

No provision.

Possible Proposals

Uniform accrual rule

Some have suggested that a uniform accrual rule be used in testing whether a qualified plan is top heavy. Thus, in determining whether the present value of cumulative accrued benefits for key employees exceeds 60 percent of the present value of cumulative accrued benefits for all employees, cumulative accrued benefits would be uniformly measured by applying the fractional rule.

Vested accrued benefits

Some have suggested that benefits taken into account in determining a plan's top-heavy status be limited to vested accrued benefits, rather than all accrued benefits.

Reduced overall limits

It also has been suggested that it is appropriate to further reduce overall limits of contributions and benefits that can be provided to key employees in a top-heavy or super top-heavy plan.

Analysis

Those favoring the adoption of a uniform accrual rule for purposes of top-heavy calculations argue that a uniform rule is easier to administer. In addition, they note that adoption of a uniform rule may be necessary to limit an employer's ability to manipulate accrued benefits merely to avoid application of the rules for top-heavy plans. Under present law, they argue that some plans have provided for early accrual of substantial benefits for rank-and-file employees while delaying accruals by the key employees. For example, non-key employees could accrue benefits based on all years of service while key employees could accrue only on years of participation. Under this approach, the benefits provided for non-key employees may be sufficient to permit the plan to avoid top-heavy status. Some would argue that non-key employees are benefited by this approach because they accrue plan benefits more rapidly. Because the plan avoids becoming top heavy, however, it can provide deferred vesting (typically 10-year vesting). Many non-key employees do not continue working for the employer long enough to have a nonforfeitable right to retirement benefits from the plan and, therefore, they often do not receive those accrued benefits. Testing top-heavy status by taking into account only a uniform rate of accrual (some suggest the fractional rule) would correct this anomaly.

Those opposing adoption of a uniform accrual rule argue that it would increase the administrative burden of maintaining qualified plans. They argue that plans that actually use the three-percent or the 133-1/3-percent rule would be forced to make dual calculations of each participant's accrued benefit—one using the plan's method, to reflect actual benefit accruals, and a second calculation, using the fractional rule, merely to determine whether the plan is top heavy.

In addition, they argue that the top-heavy calculation is used both to determine top-heavy and super top-heavy status (a plan is super top heavy if more than 90 percent of the cumulative accrued benefits are provided for key employees). Thus, they argue, at least in testing for super top-heavy status, it is particularly inappropriate to measure cumulative accrued benefits under the fractional rule, because the top-heavy plan is required to provide immediate accrual of the top-heavy minimum benefits and accelerated vesting.

Vested accrued benefits

Others argue that it is inappropriate to determine top-heavy status by evaluating all accrued benefits. Because many plans provide deferred vesting (typically 10-year cliff vesting), many non-key employees never earn a nonforfeitable right to those accrued benefits. Key employees, on the other hand, typically have more stable working patterns and are more likely to vest. Thus, in actuality, the percentage of benefits actually provided to key employees is greater than that suggested by comparing all accrued benefits. They argue, therefore, that top-heavy status should be determined by testing whether the vested accrued benefits provided for key employees exceed 60 percent (90 percent, in determining super top-heavy status) of the total vested accrued benefits.

Reduced limits for key employees

Proponents of the proposal to reduce the overall limits on contributions and benefits for key employees argue that it is inappropriate to provide very high benefit levels for key employees in a plan that delivers few benefits to non-key employees. For a more complete discussion of this issue, see Part V. A., "Overall Limits on Contributions and Benefits".

D. Benefit Forfeitures

Present Law and Background

To ensure that employees with substantial periods of service with the employer do not lose plan benefits upon separation from employment, ERISA and the Code generally require: (1) that a participant's benefits be fully vested upon attainment of the normal retirement age specified in the plan; (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.

When a participant separates from service, nonvested benefits may be forfeited. In a defined benefit pension plan forfeitures may not be used to increase promised benefits because benefits must be definitely determinable, but must be used to reduce future employer contributions or to offset plan administrative expense.

The treatment of forfeitures in a defined contribution plan depends on whether or not the plan is a money purchase pension plan. In a defined contribution plan that is not a money purchase plan (e.g., a profit-sharing or stock bonus plan), forfeitures may be reallocated to the remaining participants under a formula that does not discriminate in favor of employees who are officers, shareholders, or highly compensated. These reallocated forfeitures increase the benefits of remaining participants. Alternatively, forfeitures can be used to reduce future employer contributions.

A money purchase pension plan, like a defined benefit plan, is subject to the requirement that benefits be definitely determinable. Accordingly, a money purchase plan must contain a definite contribution formula. The Code also provides that forfeitures may not be used to increase benefits but must be applied to reduce future employer contributions or administrative costs.

Administration Proposal

The Administration proposal would create uniform rules for forfeitures under any defined contribution plan. Under the proposal, forfeitures (including those arising in a money purchase pension plan) could be either (1) reallocated to the accounts of other participants in a nondiscriminatory fashion, or (2) used to reduce future employer contributions or administrative costs.

Analysis

Though money purchase pension plans are defined contribution plans, they (unlike profit-sharing or stock bonus plans) are also pension plans, subject to more restrictive rules affecting distributions and forfeitures. Because of this status, arguments have developed over whether it is more appropriate to develop uniform forfeiture rules for defined contribution plans or uniform forfeiture rules for pension plans.

Those favoring uniform forfeiture rules applicable to all defined contribution plans argue that distinctions should be made based on the definition of the promised benefit. The accrued benefit in a money purchase pension plan, like the accrued benefit in any other defined contribution plan, is the account balance. Accordingly, they argue that forfeitures should be equally available to increase benefits under all defined contribution plans.

Those arguing in favor of uniform rules for pension plans stress the nature of the benefit. If pension plans are designed to provide a definitely determinable benefit, and money purchase plans are to be considered pension plans, they suggest that it is inappropriate to allocate forfeitures to increase those otherwise "definitely determinable" benefits.

IV. WITHDRAWAL OF BENEFITS UNDER CERTAIN TAX-FAVORED PENSION AND DEFERRED COMPENSATION ARRANGEMENTS

The rules for certain tax-favored pension and deferred compensation 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 withdrawn on account of plan termination or an employee's separation from service, disability, or death. In-service withdrawals are not permitted under a qualified pension plan before normal 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 generally may permit the withdrawal of employer contributions after the expiration of a stated period of time (e.g., 2 years or longer) or after the occurrence of a stated event (e.g., hardship). Hardship distributions may also be permitted under a tax-sheltered annuity investing in a mutual fund. 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, stock bonus, or pre-ERISA money purchase pension plan). Generally, except for hardship, these benefits may not be distributed before an employee attains age 59-1/2 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 and of certain tax-exempt organizations are not permitted to be made available earlier than when the employee separates from service or is faced with an unforeseeable emergency. (See the discussion, in Part II.D., above, relating to Unfunded Deferred Compensation Arrangements of State or Local Governments and Tax-Exempt Organizations.)

A. Uniform Minimum Distribution Rules

Present Law and Background

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 may be 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).

Under present law, distributions are generally required to commence by April 1 of the calendar year following the calendar year in which (1) the employee attains age 70½ or (2) the employee retires, whichever is later. If an employee is a 5-percent owner (sec. 416(i)) with respect to the plan year ending in the calendar year in which the employee attains age 70½ then the required beginning date is generally April 1 of the calendar year following the calendar year in which the employee attains age 70½ even though the employee has not retired.

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

Present law provides after-death minimum distribution requirements for tax-sheltered annuities similar to the rules for qualified plans.

IRAs

Present law provides after-death minimum distribution rules for 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.

Administration Proposal

Under the Administration proposal, uniform minimum distribution rules would be applied to distributions before and after the death of any participant.[34] These rules would apply to all tax-favored pension and deferred compensation plans, including tax-sheltered annuities. The proposal would provide simplifying modifications to the minimum required distribution rules.

The sanction for failure to make a minimum required distribution would be changed from plan disqualification to a 50 percent nondeductible excise tax on the amount that should have been distributed in excess of what actually was distributed. This tax would be imposed on the individual required to take a distribution, but, under certain circumstances, the individual would be given a right of recourse against the plan.

Other Proposals

1984 Treasury Report

The 1984 Treasury report was similar to the Administration proposal with certain modifications. First, the proposal would have required commencement of benefits under all tax-favored retirement vehicles in the year in which the participant attained age 70½, without regard to whether the participant is a 5-percent owner or whether the participant has retired.

Minimum distribution rules

Some have proposed that the present-law minimum distribution rules for withdrawals from tax-favored pension and deferred compensation arrangements (and the similar rules for IRAs) should be

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[34] The Administration proposal does not provide a detailed definition of these uniform minimum distribution rules.

replaced with a new uniform set of minimum distribution rules that would be enforced by imposition of an excise tax. The new rules would also apply to tax-sheltered annuity contracts. The new rules would impose minimum distribution requirements both in the case of retirement distributions and in the case of distributions after the death of the participant. Generally, distributions would be required to commence no later than April 1 of the year following the taxable year in which the participant attains age 70½ and would have to be sufficiently rapid so that each annual payment is at least equivalent to 70 percent of the annual payment that would result if benefits were paid in the form of a straight life annuity over the life of the participant.

In addition, the proposal would provide that benefits payable after the death of the participant would be required to be paid to the beneficiary within three years after the participant's death. An exception would be provided if the beneficiary is the surviving spouse so that the minimum distribution rules would be applied as if the surviving spouse were a participant in the plan.

Analysis

It is argued that the Administration proposal with respect to minimum distribution requirements represents an attempt to rationalize both the rules for minimum distributions and the sanctions for failure to take a minimum required distribution. In general, the minimum distribution rules are designed to strike a balance between concerns that retirement savings must last a lifetime and should not be depleted too rapidly, and concerns that, for people with ample wealth, the favorable tax treatment of these accumulations should not encourage their use for tax deferral and estate planning rather than for retirement income. In particular, an objective of the minimum distribution rules is to require that distribution of tax-favored retirement savings must begin during a period generally considered to be an individual's retirement years in a pattern that is consistent with retirement income goals.

Distribution during retirement years

One of the issues presented by an attempt to rationalize the minimum distribution rules is whether it is appropriate to set a specified age at which payments of retirement benefits must commence. For most employees, present law uses separation from service after age 70½ as the time when benefit distributions are to begin. However, for five-percent owners and for all IRA owners, distributions are required to commence at age 70½ without regard to separation from service.

The lack of uniformity in these provisions complicates the rules for rollovers. Under present law, restrictions are applied to portability of funds between a qualified plan and an IRA or another qualified plan because of varying restrictions applicable to plan withdrawals.

In addition, the rules have been criticized because they allow longer deferrals for employees of large companies that have no five-percent owners. Further, cases have arisen in which the time of separation from service is difficult to determine. For example, some employees may appear to cease their regular duties, but continue to work in connection with "consulting" agreements in order to postpone the commencement of benefit payments.

The 1984 Treasury report proposal would have eliminated separation from service as a test and would have required that distributions from tax-favored pension and deferred compensation arrangements begin at age 70½. Proponents of the proposal emphasize that a uniform minimum distribution requirement for tax-favored pension and deferred compensation arrangements would permit greater flexibility and simplicity under the rules for tax-free rollovers. It is also argued that the proposal would ease administration in the private and public sectors by eliminating the need for a subjective test to determine when withdrawals should begin.

Those opposed to the 1984 Treasury report proposal argue that individuals who continue in gainful employment after age 70½ should not be required to deplete their retirement savings. Because one of the goals of the private pension system is to remove pressure from social security, it has been suggested that allowing employees to delay receipt of their retirement benefits (1) eliminates a disincentive to continued employment, and (2) creates greater financial security in the private pension system. It is also argued that application of the minimum distribution requirement after age 70½ may tend to encourage the retirement of productive employees.

Rate of required distributions

The second objective of the minimum distribution requirements is to require that a minimum amount of tax-favored retirement savings will be distributed annually during the retirement period. These rules raise policy questions regarding the level of distributions that should be required and the appropriate sanction in the event required distributions are not made.

In recommending that the minimum required distribution be simplified, the Administration expressed its belief that the present-law rules are difficult for plan administrators and the IRS to administer. Proponents of the Administration proposal believe that the rules of present law for determining required distributions can be simplified. In addition, they suggest that the present-law sanction of plan disqualification for failure to make required distributions is inappropriate because it may penalize employees who did not benefit from the violation and who were not in a position to prevent it.

Excise tax

Some have argued that the severe penalty of plan disqualification is sufficient to prevent taxpayers from delaying commencement of retirement benefits as a means of avoiding income tax. They believe that a 50-percent excise tax is appropriate only if the amount of the minimum required distribution for any participant can be easily measured. On the other hand, it is argued that the severity of the disqualification sanction for violating the minimum distribution requirements limits its effectiveness because the Internal Revenue Service may be reluctant to impose it.

Others have questioned whether a 50-percent excise tax is appropriate if the top marginal income tax rate is lower than 50 percent, such as the 35-percent top rate in the Administration proposal. If the level of the tax is intended to parallel the structure of present law in which the level of the excise tax equals the top marginal rate, then some argue that the level of the excise tax under the proposal should equal the top marginal tax rate under the proposal.

Some argue, however, that the level of the excise tax (i.e., 50 percent) on IRAs under present law is confiscatory because, for an individual in a 50-percent tax bracket, the total tax on a benefit is 100 percent (a 50 percent income tax plus a 50-percent excise tax). Others suggest that such a tax is an effective incentive to comply with the minimum distribution rules. To create a parallel incentive under the proposal, they beleive that, if the top tax rate is reduced to 35 percent, the excise tax should be increased to 65 percent.

Proponents of the 50-percent tax point out that it has been applied, since 1975, to IRAs. They argue that the tax is a simple means of recapturing the tax benefits of undue deferral and that it has been effective in encouraging timely distributions.

Some who support the excise tax believe that the 50-percent tax suggested by the Administration proposal is sufficient to recapture the benefits of tax deferral; others argue that, in light of the possibly extended deferral period, it is necessary to impose a higher excise tax either at a flat rate or pursuant to a sliding scale based on length of deferral, actual investment experience, or some combination of similar factors.

Others have suggested that the level of the excise tax could increase as the ratio of earnings to the total plan assets increases. They believe that such an approach would produce an excise tax that reflects actual yield and the length of the deferral, does not disproportionately affect lower-income taxpayers and, therefore, is less regressive.

B. Distributions Before Age 59½

Present Law and Background

Generally, under present law, a 10-percent additional income tax is imposed on withdrawals from qualified plans with respect to five-percent owners who have not attained age 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, withdrawals under a tax-sheltered annuity invested in a custodial account (i.e., a mutual fund) may not commence 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, withdrawals 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.

Administration Proposal

Withdrawal restrictions

The withdrawal restrictions currently applicable to tax-sheltered annuities investing in custodial accounts generally would be extended to all tax-sheltered annuities. Thus, early distributions from a tax-sheltered annuity would be prohibited unless the withdrawal was made on account of death, disability, separation from service, or attainment of age 59½. Financial hardship would be eliminated as an event permitting early withdrawal.

In addition, a qualified cash-or-deferred arrangement would not be permitted to make a distribution other than on account of death, disability, separation from service, or plan termination. Thus, the attainment of age 59½ and occurrence of a hardship would not be permitted withdrawal events.

Recapture tax on early withdrawals

Under the Administration proposal, the 10-percent additional income tax on withdrawals prior to age 59½, death, or disability would be extended to early distributions by any participant in any tax-favored pension or deferred compensation arrangement. In addition, the tax generally would be increased to 20 percent.

The 20-percent tax would be lowered to 10 percent if the early withdrawal was made on account of (1) the purchase of the individual's first principal residence, (2) the payment of college expenses for a dependent of the individual, or (3) unemployment during the period following the cessation of unemployment benefits. In addition, the penalty tax would be waived for distributions after attainment of age 50 if the distribution is one of a scheduled series of substantially level payments under a single or joint life annuity or under a term certain of at least 180 months commencing on account of retirement under the plan.

Other Proposals

1984 Treasury Report

The 1984 Treasury report proposal was similar to the Administration proposal, except that the 1984 report did not waive the 20-percent additional income tax on early distributions for payments to certain participants after age 50.

Withdrawals before age 59½

Some have proposed adopting a uniform set of rules applicable to withdrawals from or under all tax-favored pension and deferred compensation arrangements. Under this proposal, all distributions to plan participants (including the person on whose behalf an IRA or tax-sheltered annuity is maintained) before age 59½ would be treated as ordinary income when distributed, except to the extent they represent a return of nondeductible employee contributions. Distributions after age 59½ would be eligible for favorable tax treatment.

Under this favorable tax treatment, the recipient of a distribution after age 59½ from a tax-favored pension or deferred compensation arrangement would be entitled to a credit equal to a percentage of the taxable portion of the distribution. The credit percentage could be set at 15 percent to provide a strong incentive for retirement savings.

The proposal would provide an exception to the age 59½ rule in the case of distributions after the death of the participant. Amounts paid as a death benefit would be eligible for the 15-percent tax credit even if the recipient has not attained age 59½.

Analysis

Under present law, the goal of encouraging retirement savings to be used to meet retirement income needs has led to the imposition of (1) restrictions on pre-retirement withdrawals, or (2) penalty taxes on such withdrawals.

Effect of restrictions

Present law imposes withdrawal sanctions with respect to certain tax-favored retirement arrangements and requires withdrawal restrictions to be provided under others. If withdrawal restrictions are provided, they may apply to some employees and not to others participating in the same arrangement. In addition, present law may permit tax-free rollovers or direct transfers of assets between arrangements with differing withdrawal rules.

A qualified pension plan is not permitted to provide for distributions to a participant who has not separated from service. Those who support this restriction believe that it has effectively protected retirement savings against preretirement use and that it has not interfered with the accumulation of substantial amounts in pension plans.

Some believe that withdrawal restrictions are appropriate for tax-favored retirement savings arrangements. They argue that, if withdrawals can be made from these programs at any time or for any reason, then people will treat them as ordinary savings accounts with favorable tax features. They also argue that it is inappropriate to require taxpayers who are unable to accumulate significant savings to subsidize the general purpose savings of those who are more fortunate.

Proponents of restrictions on withdrawals contend that they operate to assure a source of long-term capital that is needed by the economy. They also argue that the restrictions are needed to prevent these savings arrangements from competing unfairly with investment media subject to less favorable tax treatment.

Some have suggested that present law, which does not uniformly prevent preretirement withdrawals from tax-favored retirement arrangements, fails to target the restrictions to the appropriate class of taxpayers. Those who support this view believe that all individuals either should be (1) prevented from taking preretirement distributions, or (2) subject to additional tax for taking them, as suggested in the Administration proposal.

On the other hand, some believe that premature withdrawal restrictions or penalties constitute an inappropriate impediment to savings. This group argues that individuals are less likely to save or to negotiate for retirement benefits in lieu of current wages if they do not have easy access to their benefits. They believe that low- and moderate-income people cannot afford to commit savings to an arrangement under which withdrawals cannot be made for an extended period. Accordingly, they argue that withdrawal restrictions discourage many people from participating in tax-favored pension and deferred compensation programs and retard savings. They believe that elimination of the restrictions will lead to an increase in the level of retirement savings because people will make larger contributions and will not make inappropriate withdrawals before retirement.

Others counter this argument by pointing out that the absence of withdrawal restrictions may lead to greater short-term savings, but would not create any true increases in retirement savings. Under this view, low-income taxpayers, who are more likely to save if they have access to their funds, will withdraw tax-favored savings in order to meet current consumption needs. Some argue that middle- and upper-income taxpayers, who have a greater propensity to save without regard to the existence of restrictions on access, would not save more on a tax-favored basis merely because there were no withdrawal restrictions.

Under present law, if an employee separates from service with an employer and the present value of the employee's interest in qualified plan benefits does not exceed $3,500, the employee's interest may be distributed without the employee's consent. It is argued that the withdrawal restrictions should not apply under these circumstances.

Others counter that employees who receive involuntary distributions may roll over the benefits, tax free, to an IRA. They contend that the withdrawal restrictions should not be waived because mobile employees should be encouraged to save plan benefits for retirement.

Some hold the view that retirement savings should not be singled out for favorable tax treatment. Thus, some argue that savings for higher education are as important as savings for retirement and should also be encouraged by the tax law. Others believe that tax-favored treatment should also be accorded to savings for the purpose of acquiring a home. Under this view, it has been suggested that, even if tax-favored retirement arrangements have restrictions on withdrawals before retirement, exceptions should be provided to permit withdrawals for specific nonretirement purposes. The Administration proposal contains a variation of this approach by lowering the additional income tax on early withdrawals in the case of withdrawals (1) to purchase a first principal residence, (2) to pay higher education expenses, or (3) on account of long-term unemployment.

Others point out that the Administration proposal list of items that deserve special consideration for purposes of reducing the additional income tax on early withdrawals may not be exhaustive. They suggest that there may be other circumstances under which it is appropriate to reduce the tax.

The opponents argue that government support of other social goals, such as higher education, should be addressed separately so as not to provide a mechanism to undermine the retirement security goal of qualified plans and IRAs. They argue that the fact that retirement is so distant in time and of such uncertain duration makes it a unique problem, which should be treated under the tax laws.

Some argue that it is simpler to retain the present-law level of tax (i.e., 10 percent) rather than attempt to identify all events deserving a reduction in tax. They believe that rules permitting nonretirement withdrawals for specific purposes will be difficult to administer.

Duration of restrictions

Withdrawals on or after age 59½ has generally been used as the cutoff for determining whether an additional income tax applies to pre-retirement withdrawals. Age 59½ becomes a substitute for early retirement age under this construction and was originally added because of the difficulty encountered in determining when an employee has retired. For example, it was generally believed that the policy goal of guaranteeing that retirement funds are used for retirement purposes would not be served if the penalty is waived for distributions to an individual who may be terminating employment with one employer in order to go to work for another employer.

On the other hand, in some industries and occupations, retirement may commonly occur before age 59½. Thus, the Administration proposal would waive the premature distribution penalty for certain annuity payments after age 50. Some would argue that this exception, which is only provided for annuity forms of payment, is consistent with the general goal of using tax-favored retirement arrangements to provide a stream of retirement income.

In addition, some question whether the exception for certain payments after age 50 will adequately address the problems of early retirement in certain industries. For example, workers in the construction industry normally provide for early retirement after 20 years of service. In addition, individuals who perform hazardous duties, such as police and firefighters, often retire well before age 50. Consequently, some argue that it is necessary to adopt additional exceptions to the withdrawal restrictions to take account of the unique characteristics of some industries. The exception raises the question of whether the rough justice achieved by the age 59½ outweighs the complexity and difficulty of administration presented by the proposed exceptions to the general rule.

Others argue that the penalty applies only to amounts that are consumed prior to 59½. They argue, for example, that amounts rolled over to an IRA are not subject to the tax. In addition, those who retire prior to age 59½ but after age 50 could avoid the penalty by taking annuity-type distributions. They believe this may protect participants in hazardous lines of duty or early-out union plans while encouraging the use of the monies for retirement income purposes. Others argue that a life annuity should be permitted at any age without penalty as long as the participant has retired under the plan.

Level of sanction

Similar questions arise with respect to the Administration proposal to increase the present 10-percent additional income tax on early withdrawals to 20 percent except in the case of withdrawals for certain purposes, such as purchase of a first principal residence. Some believe that the present sanction is not sufficiently high to discourage early withdrawals. They point out that, for taxpayers whose income is taxed at high marginal rates, the sanction may be neutralized by the tax-free compounding of interest after a period of five to six years. This, they argue, is an insufficient deterrent to the use of retirement funds for nonretirement purposes.

The following table (Table 6) shows the number of years of tax-free growth needed on an IRA contribution to offset a penalty for early withdrawals. For example, in the case of a taxpayer in a 35-percent tax bracket, who earns 12 percent interest on IRA contributions, the benefit of tax-free growth offsets a 10-percent additional income tax in 4.4 years, whereas a 20-percent tax is not offset until the contributions have been held for 9.6 years.

Table 6.—Breakeven Period (in Years) for Tax-Deferred Savings Under Various Tax, Earnings, and Penalty Assumptions

Earnings per year	Marginal tax rate					
	25%		35%		50%	
	Penalty		Penalty		Penalty	
	10%	20%	10%	20%	10%	20%
8%	7.7	16.6	6.4	14.0	5.9	13.5
10%	6.2	13.5	5.1	11.4	4.8	11.0
12%	5.3	11.4	4.4	9.6	4.1	9.3

On the other hand, some believe that a higher sanction would discourage retirement savings by most taxpayers and would be particularly troublesome to workers who expect to retire before age 59½. They believe that the sanction should not be set at a rate that discourages early withdrawals by taxpayers who are subject to the highest marginal tax rates because such a sanction would be excessive for taxpayers whose income is taxed in lower brackets. Some argue that this regressivity of the sanction is inappropriate. Similarly, they point out that the general reduction in tax rates proposed by the Administration makes the effect of increasing the additional income tax from 10 to 20 percent more significant.

An alternative to a flat additional income tax that would deal with the problem of regressivity would be to impose a tax that varies depending upon the marginal tax rate of the taxpayer. For example, the tax could be set at a percentage of the marginal tax rate of the taxpayer. Some would argue that such a proportionate tax, although more fair, would add complexity to the income tax system. Also, higher-income individuals may be able to reduce the level of the tax by reducing their marginal tax rates.

Another possible alternative would be to retain the present-law level of the additional income tax (i.e., 10 percent) so that the effect of regressivity is reduced.

Another alternative to a flat additional income tax would be to apply the tax on a sliding scale designed to reflect the actual yield and the length of the deferral. For example, some have proposed to have the level of the tax reflect the ratio of earnings to total plan assets. Some argue that this approach would assess the additional income tax based on the level of tax-deferred earnings and, therefore, would more accurately recapture a portion of the tax benefit.

Finally, those opposed to increasing the additional income tax on premature withdrawals and the extension of the tax to all participants in all tax-favored retirement arrangements point out that the sanction is more onerous at low interest rates. They argue that if the sanction is increased, it will adversely affect people who cannot accumulate sufficient retirement savings to obtain high investment yields.

Tax-sheltered annuities

Those who support extending the early withdrawal restrictions to tax-sheltered annuities argue that all tax-favored pension and deferred compensation arrangements should be subject to consistent withdrawal restrictions. They further support the limitation on withdrawals prior to 59½ from a tax-sheltered annuity on the theory that these annuities are often salary reduction arrangements. They believe it is appropriate, therefore, to treat tax-sheltered annuities similar to qualified cash or deferred arrangements.

On the other hand, some suggest that tax-sheltered annuities should not be subject to the same withdrawal restrictions as qualified plans as long as the investment media available to tax-sheltered annuities are limited. They also argue that, if the goal is uniformity of treatment, the application of constructive receipt principles to tax-sheltered annuities should be repealed.

C. Uniform Tax Treatment of Distributions

Present Law and Background

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 five 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 to distributions of annuities from qualified plans. Under the special rule, if an individual will receive all employee contributions within the first three 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.

Under present law, if current life insurance protection is provided for a plan participant out of deductible employer contributions or trust earnings, then the cost of the protection is currently includible in the participant's income. Special rules apply to self-employed individuals. In addition, with respect to the contract of which the life insurance is a part, the participant's basis in the plan may be increased by the amount of these costs (PS-58 costs) included in income.

Generally, if a plan is disqualified, participants must currently include their benefits in income to the extent their benefits are vested. However, in at least one case, a participant who withdrew an account balance from a disqualified profit-sharing plan was eligible to roll over, tax free, the portion of the distribution representing contributions and earnings for years prior to the disqualification of the plan.

Administration Proposal

The Administration proposal would apply uniform rules to the tax treatment of distributions under tax-favored retirement vehicles, including tax-sheltered annuities and IRAs.

Under these uniform rules, the following changes would be made: (1) constructive receipt would be eliminated as an event triggering taxation of benefits under a tax-sheltered annuity; (2) 10-year income averaging and special capital gains treatment would be eliminated; and (3) the special treatment of net unrealized appreciation in employer securities would be repealed.

In addition, the proposal would modify the basis recovery rules applicable to employee after-tax contributions. Under the proposal, amounts received prior to the annuity starting date would be treated first as a taxable distribution and last as a nontaxable return of employee contributions. Amounts received after the annuity starting date would be taxed under modified basis recovery rules, applicable to all annuity contracts. The special three-year rule for qualified plans would be eliminated.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

The Bradley-Gephardt bill would repeal 10-year income averaging applicable to certain lump-sum distributions.

S. 1006 and H.R. 2222 (Kemp-Kasten)

Same as Bradley-Gephardt.

H.R. 1377 (Stark)

Under H.R. 1377, the benefits of 10-year income averaging would be reduced by 20 percent in the case of any revenue enhancement year. A revenue enhancement year would mean any taxable year a portion of which is within the period that begins on January 1, 1986, and ends on December 31, 1989.

S. 556 (Chafee)

Under S. 556, the benefits of 10-year income averaging would be reduced by 15 percent in the case of any revenue enhancement year. A revenue enhancement year would mean any taxable year a portion of which is within the period that begins on January 1, 1986, and ends on December 31, 1989.

Distributions from disqualified plans

It has been suggested that a distribution to a highly compensated employee from a disqualified plan should not be eligible for 10-year income averaging or tax-free rollover treatment.

Basis recovery rules

Some have proposed that, in the case of annuities paid from tax-favored pension and deferred compensation arrangements, the present law disparity in tax treatment depending on whether or not nondeductible employee contributions are recovered within three years of the annuity starting date should be eliminated. Those who support this proposal recommend that annuity distributions be treated as coming first out of nondeductible employee contributions (i.e., basis) and then from other amounts. Thus, under this proposal, no amount would be taxable to the recipient until after all nondeductible employee contributions were recovered, when all distributions would become taxable.

Analysis

Under present law, special tax treatment (i.e., 10-year income averaging, capital gains treatment, treatment of net unrealized appreciation in employer securities, and three-year basis recovery) has been accorded to certain withdrawals of tax-favored retirement savings. In connection with the consideration of tax reform, it is argued that it is appropriate to evaluate whether this special tax treatment continues to be justified.

10-year income averaging and capital gains treatment

The 10-year income averaging and capital gains provisions of present law were originally intended to mitigate the effect of the graduated tax structure and higher marginal tax rates when retirement benefits are received in a single sum.

The Administration proposes to eliminate 10-year income averaging and capital gains treatment for lump sum distributions. Some who favor the proposal believe that the present rules are inconsistent with the goal of encouraging the use of retirement savings for retirement purposes because they encourage premature distribution of those savings and may result in the dissipation of funds that will be needed during retirement. They believe that tax-free rollovers, rather than lump sum distributions, should be encouraged because amounts rolled over are more likely to be retained for use during retirement. At a minimum, they argue, the special treatment of lump sum distributions should be limited to taxpayers who have attained age 59½.

Further, some suggest that spouses may receive greater survivor benefits under a profit-sharing or stock bonus plan if the special treatment of lump sum distributions is repealed. Under this view, employees are less likely to withdraw a lump sum distribution from a profit-sharing or stock bonus plan if they are not eligible for 10-year income averaging. Therefore, unless the spouse of the employee has waived any right to a survivor benefit, the spouse will receive 100 percent of the account balance if the employee dies before withdrawing it.

Some also believe that the special treatment for lump sum distributions has led to unduly complicated rules designed to prevent abuse. They argue that the rules for tax-free rollovers could be substantially simplified if it were not necessary to prevent inappropriate eligibility for 10-year income averaging and capital gains treatment.

Those who favor the Administration proposal have pointed out that the tax savings due to 10-year income averaging is diminished if tax rates are reduced and tax brackets are widened. They argue that, for many taxpayers, the apparent advantages of 10-year averaging over tax-free rollovers are offset by the requirement that, if 10-year averaging is elected, then tax must be paid on the distribution for the year of the distribution instead of the year in which the funds are used. In addition, they argue that the elimination of the special rules for lump sum distributions is consistent with the Administration proposal to repeal the regular income averaging rules.

On the other hand, opponents of the proposal argue that, even if the tax-free rollover rules are expanded and made less complex, elimination of the rules for lump sum distributions will result in hardships. This group argues that an individual's retirement income needs may be greater at the time of retirement than in later years. For example, some people may need a large amount of cash in the year of retirement to purchase a home suitable for retirement. They argue that, under present law, the home may be purchased without incurring any substantial debt but that, if the Administration proposal is adopted, it would be necessary to buy the home subject to a mortgage and to make the mortgage payments from funds held in a tax-favored retirement arrangement. They are concerned, therefore, that the Administration proposal could interfere with the objectives of retirees who do not wish to be burdened with debt. They also argue that a retiree who uses a lump sum distribution to acquire a home for retirement without a mortgage has used the distribution for retirement purposes.

Those who oppose the Administration proposal argue that the combination of a repeal of the special rules for lump sum distributions and the proposal to impose tax sanctions on distributions before age 59½ would cause hardships for people who plan to retire before age 59½ and purchase a home for retirement.

Finally, those who oppose special treatment of lump sum distributions argue that plans will be required to retain plan benefits longer if employees are not eligible for 10-year income averaging. This, they argue, will impose additional recordkeeping burdens on plan administrators.

On the other hand, some argue that the longer retention of plan benefits is consistent with the goal of encouraging employees to use retirement savings for retirement purposes. Also, they point out that present law permits plans to make involuntary distributions to employees who have separated from service if the present value of the pension benefit does not exceed $3,500. This, they suggest, eliminates any recordkeeping burdens with respect to de minimis amounts of benefits.

Net unrealized appreciation

The arguments asserted for eliminating the special treatment of net unrealized appreciation (NUA) in employer securities generally are similar to the arguments presented for eliminating 10-year income averaging. Thus, it has been suggested that NUA treatment merely provides a mechanism for using retirement funds as a non-retirement investment. The taxpayers who can best afford to avoid income tax on pension benefits by holding employer securities may not be the class of taxpayers for whom special tax treatment is justified.

In addition, those who support the proposal to repeal the special treatment of net unrealized appreciation in employer securities point out that, under present law, an exemption from tax is provided if the securities have not been sold before the employee's death. The NUA is excluded, not merely deferred, because heirs take the securities with a stepped up basis. They note that this exclusion is available even though there is no longer any general estate tax exclusion for qualified plan benefits. They argue that the provision of additional tax benefits for employer securities is inappropriate.

However, some suggest that the treatment of NUA is necessary for individuals whose sole retirement benefits are employer securities. They assert that such an individual should not be forced to bear the administrative expense of maintaining an IRA in order to continue the deferral of income tax on the benefits. They also point out that individuals who receive employer securities would be taxed on the appreciation at capital gains rates when the securities are sold. On the other hand, if the securities are rolled over to an IRA, the gain on the sale of the securities is converted to ordinary income.

On the other hand, those who favor the Administration proposal have pointed out that people whose pension plans have distributed securities or property other than employer securities have the same problem and that no similar relief is provided for them. They argue that the tax benefit of NUA treatment should not depend on whether the property distributed is employer securities.

Basis recovery rules

The rate at which an individual recovers his or her basis (e.g., investment in the contract) under a tax-favored retirement arrangement presents complicated measurement problems in addition to the tax policy issue of when a taxpayer should be taxed on income. In the past, proposals to permit nondeductible IRA contributions have been rejected, in part, because of the administrative complexity that basis recovery rules would create.

The Administration proposal would reverse the basis recovery rules for preretirement distributions. It is argued that this proposal (i.e., to apply an income first rule to preretirement distributions) is consistent with the view that there should not be an incentive to use retirement funds for nonretirement purposes. Some have pointed out, however, that the Administration does not propose to reverse the general basis recovery rules for life insurance contracts and have suggested that retirement funds should have at least as favorable treatment.

Supporters of the repeal of the three-year basis recovery rule for retirement distributions argue that it is intended to eliminate distinction in tax treatment that benefits a limited class of taxpayers. Proponents of repeal claim that this rule, which was originally added merely for administrative simplicity, creates an unfair cliff for taxpayers whose employee contributions are not recoverable within three years after retirement. They also point out that the Administration proposal would ensure that the remaining basis would not be lost if an individual dies before all basis is recovered.

On the other hand, it is argued that the basis recovery rules are so complicated that it is inappropriate to apply these rules where the amount of basis to be recovered is recoverable in a short period of time. For example, a possible alternative to the Administration proposal would be to change the three-year basis recovery rule of present law to a one-year rule.

Further, some suggest that the basis recovery rule that avoids any administrative complexity would be to permit participants to recover all basis first under qualified plans. This rule could be applied to all distributions or, alternatively, only to post-retirement distributions.

Those who oppose this approach argue that it would exacerbate the problem under present law under which an individual's tax liability increases (and, therefore, the net benefit decreases) after all basis has been recovered. Moreover, they assert that such a rule ignores the economic reality that, if an individual receives an annuity form of benefit, a portion of each annuity payment represents a return of the individual's basis.

Some argue that participants should not be entitled to increase basis by the amount of PS-58 costs included in income. They suggest that the amounts used to provide the life insurance protection are depleted and, therefore, it is inappropriate to increase basis by these amounts.

Distributions from disqualified plans

Some have suggested that distributions to highly compensated employees from disqualified plans should not be eligible for tax-free rollover treatment or 10-year income averaging. Those who support this proposal point out that one of the primary benefits of the tax-favored treatment of pension and deferred compensation arrangements is the deferral of tax on plan earnings. They assert that, if highly compensated employees are essentially allowed to retain the benefit of deferral, there is little incentive to continue to satisfy the qualification requirements.

For example, if a plan is maintained on a nondiscriminatory basis for many years and, in the year that the highly compensated employees retire, the plan is amended to exclude all rank-and-file employees, some believe that present law permits the highly compensated employees to roll over, tax free, the accumulations from all previous years. Those who support the proposal argue that this is an inappropriate manipulation of the tax incentives.

Those who oppose the proposal argue that any abuses of the tax incentives for tax-favored pension and deferred compensation arrangements should be dealt with by penalizing only those individuals who actually cause the abuse. They suggest that it would be more effective to enact severe penalties for individuals who intentionally manipulate the tax incentives.

D. Tax-Free Rollovers

Present Law and Background

Special treatment is provided with respect to certain distributions from tax-favored retirement 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.

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 contract may be rolled over, tax free, to an IRA or another qualified plan or contract. 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 tax-free rollover treatment. In order to avoid current taxation, a rollover must be made within 60 days after the date of the distribution.

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 generally may be distributed from the IRA and rolled over to another qualified plan unless the distribution is attributable to amounts contributed on behalf of certain owners to a 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 one 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.

Administration Proposal

The proposal would permit individuals to roll over all distributions from a tax-favored retirement vehicle to any other vehicle, regardless of the amount of the distribution provided the rollover was made within 60 days of the date of the distribution. However, rollovers would not be permitted of amounts that are minimum required distributions. (See the discussion of the uniform minimum distribution proposals, above.)

Analysis

Under present law, if an individual rolls over a benefit received from a tax-favored retirement arrangement to another such arrangement, tax is deferred until the benefit is withdrawn. This deferral of income tax on retirement benefits that are rolled over to another tax-favored retirement arrangement is an exception to the usual principle of taxation that an individual should not be permitted to turn his or her back on income. In effect, liberal rollover rules allow an individual to decide when and how a retirement benefit will be taxed.

Those who favor expansion of the tax-free rollover rules argue that further liberalization of the rules would (1) benefit an individual, who is more likely to have lower income, whose employer forces a distribution of pension benefits at a time when the individual does not want it, and (2) allow individuals to change investment media in response to changed investment opportunities.

E. Loans Under Qualified Plans

Present Law and Background

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). However, no loan is permitted under ERISA or the Code from a qualified plan to an owner-employee (i.e., a sole-proprietor or more than 10-percent portion) of the employer. Interest paid on a loan from a qualified plan is deductible (sec. 163).

Under present law, no distinction is drawn between loans to plan participants and loans to beneficiaries of plan participants. Thus, a beneficiary may be entitled to borrow from a qualified plan as long as the general requirements with respect to the loan are satisfied.

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 five 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.

Administration Proposal

Under the Administration proposal, the exception to the income inclusion rule would be modified so that the $50,000 limit on a loan would be reduced by the participant's highest outstanding loan balance during the preceding 12-month period. In addition, the extended repayment period permitted for purchase or improvement of a principal residence would be amended to apply only to the purchase of the first principal residence of the participant.

Possible Proposals

Loans to beneficiaries and separated employees

It has been suggested that it may be appropriate to provide that any loan to a beneficiary of a participant or to a separated participant would be treated as a distribution to the participant when made.

Five-year rule for repayment

Some have proposed repealing the five-year repayment requirement. Alternatively, they recommend that loans should be required to be amortized over the five year repayment period so that it would not be permissible to provide a loan with a balloon payment at the end of the five year term.

Interest deduction for qualified plan loans

Some have suggested denying an interest deduction for interest paid on loans from qualified plans.

Some have suggested that interest deductions should be denied on payments of loans that were used to make contributions to qualified plans, IRAs, or tax-sheltered annuities.

Loans for highly compensated employees

It has been proposed that highly compensated employees should not be permitted to borrow from qualified plans.

Lower limit on plan loans

Some have suggested that the dollar limit on loans from qualified plans that are not treated as distributions should be lowered.

Analysis

In the past, loans generally have been permitted from certain tax-favored pension and deferred compensation arrangements to prevent employees who need access to funds for emergencies from separating from service with the employer in order to get a distribution of qualified plan benefits. In 1982, when limits were placed on the extent to which qualified plan loans would not be treated as distributions from a plan, some argued that widespread use of qualified plan loans diminishes retirement savings and thereby undercuts the objective of encouraging retirement savings.

Some argue that it is appropriate to reexamine the circumstances under which loans will not be treated as qualified plan distributions. For example, the Administration proposal would modify the $50,000 limit on loans not treated as distributions to prevent maintenance of a permanent $50,000 loan through balloon payments and short-term bridge loans. Supporters of this proposal suggest that such loans do not fall within the stated objective for permitting qualified plan loans.

Those who support the Administration proposal have also suggested other proposals that they believe would limit the ability of individuals to utilize qualified plan loans for other than emergency needs. Some have proposed, as an addition to the Administration proposal, that loans should be required to be amortized over a five year period. They argue that this would guarantee that qualified plan loans are, in fact, repaid and would demonstrate that the loans do not dilute retirement savings.

Loans to beneficiaries

Some have also proposed that loans to beneficiaries and employees who have separated from service do not fall within the original rationale for permitting loans from tax-favored pension and deferred compensation arrangements. They argue that it is appropriate to treat loans to such individuals as distributions.

On the other hand, some would argue that beneficiaries and former employees may have emergency needs just as legitimate as plan participants. For example, they suggest that the surviving spouse of a plan participant may have the same need for access to funds that the participant had and should be permitted to borrow under the same conditions. Those who support this view argue that beneficiaries should not be forced to accelerate distributions from a qualified plan merely because of the occurrence of a financial hardship.

Limit on loans

Some have proposed that the limit on loans not treated as distributions should be lowered. For example, the limit could be reduced from $50,000 to $10,000. Those who support this approach argue that qualified plan loans are primarily designed to protect lower-paid employees who may not have access to other sources of credit.

They suggest that most lower-paid employees would not generally need loans in excess of $10,000.

Those who oppose this proposal argue that the $50,000 limit on loans generally prevents highly compensated employees from abusing the loan provisions and that many lower-paid participants may have legitimate expenses that exceed $10,000. They suggest that, because the $50,000 limit is not indexed for inflation, the value of the limit will be eroded over time and, therefore, should not be reduced.

Others have proposed providing a lifetime limit on either the dollar amount of loans (such as $100,000), the number of loans, or both. Those supporting this view argue that a lifetime limit on loans would assure that qualified plan loans are not used primarily to secure additional tax benefits of interest deductions by highly compensated employees.

Those who oppose this approach argue that a lifetime limit may adversely affect a low or middle-income employee who has legitimate emergency needs. They also suggest that a lifetime loan limit may impose significant record keeping burdens on plan administrators.

Denial of interest deduction

Some have suggested that it is appropriate to deny any interest deduction for interest paid on loans from qualified plans. They argue that present law provides an unnecessary opportunity for arbitrage by allowing employees to pay interest to qualified plans in which they participate because the interest is not currently taxed. Those who support this view assert that the long period of deferral of tax on qualified plan earnings make the earnings essentially equivalent to tax-exempt investments. They also argue that a participant who borrows from a qualified plan is essentially paying interest to himself or herself and that to allow an interest deduction under such circumstances is inappropriate.

On the other hand, some disagree that qualified plan earnings are equivalent to tax-exempt income. They argue that the limits on loans under present law are sufficient to prevent significant arbitrage opportunities.

Some argue that it is appropriate to deny interest deductions if an employer or an individual borrows to make contributions to a qualified plan, IRA, or tax-sheltered annuity. They suggest that present law provides an unnecessary opportunity for arbitrage by allowing employers and individuals to borrow to carry obligations the income on which is not currently taxed. They also point out that many financial institutions advertise the availability of loans to make plan and IRA contributions.

Loans by highly compensated employees

It has been proposed that it may be appropriate to prevent highly compensated employees from borrowing from a qualified plan. If loans are justified by claims that low-paid employees have emergency needs, some question why loans should be permitted for all highly compensated employees.

Those who support this view point to the restriction on loans by owner-employees under present law. They argue that the loan rules were not designed to benefit highly compensated employees. In addition, they point to instances under present law where some highly compensated employees use the loan rules to gain tax advantages. For example, a highly compensated employee could borrow amounts in excess of the limits when in a low tax bracket, repay the loan with low tax cost, and build up basis in the employee's interest in the qualified plan to generate significant savings after retirement.

Those who oppose this approach argue that, if highly compensated employees are not permitted to make loans, no loans will be permitted under qualified plans. They suggest, therefore, that eliminating loans for highly compensated employees would effectively eliminate all qualified plan loans.

V. TAX DEFERRAL UNDER QUALIFIED PLANS

A. Overall Limits On Contributions And Benefits

Present Law and Background

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..."[35] 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 actuarially reduced. TEFRA provided that the new $90,000 limit (but not the 100 percent of compensation

[35] S. Rpt. 97-494, 97th Cong., 2d Sess., Vol. 1, 314 (1980).

limit) is reduced if benefits commence before age 62 (rather than 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 actuarially 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 3/10 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 limits 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. Therefore, if total employee contributions do not exceed six percent of compensation, no employee contributions are counted as annual additions.

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 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 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

Subject to limits, public schools and certain tax-exempt organizations (including churches and certain organizations associated with churches) may make payments on behalf of an employee to purchase a tax-sheltered annuity contract (sec. 403(b)). Payments to a custodial account investing in stock of a regulated investment company (*e.g.*, a mutual fund) are also permitted.

The amount paid by the employer is excluded from the employee's income for the taxable year to the extent that payment does not exceed the employee's exclusion allowance for the taxable year. The exclusion allowance is generally equal to 20 percent of the employee's includible compensation from the employer multiplied by the number of the employee's years of service with that employer,[36] reduced by amounts already paid by the employer to purchase the annuity.

In addition, an increased exclusion allowance is provided for certain church employees whose adjusted gross income does not exceed $17,000. The special exclusion allowance for such employees is not less than the lesser of $3,000 or the employee's includible compensation for the year.[37]

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). Tax-sheltered

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[36] For purposes of calculating a post-1981 exclusion allowance, all years of an employee's service with an organization that is a part of a particular church (including pre-1982 years of service) are treated as years of service with one employer. Thus, although a minister or lay employee may, during the span of a career with a church, transfer from one organization to another within the particular church, or from the church to an associated organization, all service with such organizations is treated as service with a single employer. Payments made by all such organizations on behalf of an employee are also to be taken into account under the exclusion allowance formula as contributions made by a single employer.

[37] Solely for the purpose of determining includible compensation under the special rule, the includible compensation of an eligible church employee who is a foreign missionary is considered to include the amount paid by the church during the taxable year for the purchase of a tax-sheltered annuity for the employee. A church employee is a foreign missionary for a taxable year for which the employee's principal duties are the propagation of religious doctrine or the performance of sacerdotal functions or humanitarian good works for the church outside the United States.

annuities are generally defined contribution arrangements.[38] Under the overall limits, annual additions[39] 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.[40]

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.[41] The election may not be made for the same year in which a catch-up election is effective.

Administration Proposal

Employee contributions

In applying the limit on annual additions (i.e., the lesser of 25 percent of compensation or $30,000), one-half of all employee contributions would be treated as annual additions, regardless of whether such contributions exceed six percent of compensation.

Defined benefit pension plans

The maximum annual benefit (i.e., the lesser of 100 percent of compensation or $90,000) would be reduced for any participant with less than ten years of participation in the plan regardless of the participant's years of service with the employer. Thus, no plan

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[38] The Economic Recovery Tax Act of 1981 (ERTA) provided that a church-maintained retirement income program in existence on September 3, 1982, will not be considered as failing to satisfy the requirements for a tax-sheltered annuity (sec. 403(b)) merely because the program is a defined benefit pension plan (sec. 414(j)). For this purpose, a church-maintained retirement income program is considered to be in existence on September 3, 1982, notwithstanding that, after that date, the program is amended, otherwise modified, or extended to benefit other employees.

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

[40] 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.

[41] 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.

benefit could be based upon years of service with the employer prior to participation in the plan.

Combined plan limit

The combined plan limit would be repealed for participants in all plans that are not top heavy. However, a new combined benefit limit would be imposed on all participants receiving qualified plan benefits. To the extent that aggregate annual distributions made from qualified plans, IRAs, and tax-sheltered annuities exceed a dollar amount, an excise tax equal to 10 percent of the excess would be imposed. Under the proposal, the dollar amount would be 1.25 times the currently applicable defined benefit dollar limit (1.25 x $90,000 would equal $112,500 for 1985 through 1987). For example, a participant receiving aggregate annual benefits of $152,500 would be subject to an additional tax of $4,000 (10 percent of the $40,000 excess).

Tax-sheltered annuities

The Administration proposal repeals the special limits for tax-sheltered annuities.

Other Proposals

S. 409 and H.R. 800 (Bradley-Gephardt)

S. 409 and H.R. 800 generally would reduce the dollar limits on contributions and benefits provided by qualified plans, tax-sheltered annuity programs, and SEPs of private and public employers. The dollar limit on the annual additions to a defined contribution plan would be reduced from $30,000 to $20,000. The dollar limit on the annual benefit payable under a defined benefit pension plan commencing at age 62 would be reduced from $90,000 to $60,000. Conforming changes would be made with respect to the limits applicable to benefits commencing before age 62. Under the conforming changes, the dollar limit applicable to benefits commencing prior to age 62 would be reduced so that it is the actuarial equivalent of an annual benefit of $60,000 beginning at age 62. Under the bills, the dollar limit on benefits commencing at or after age 55 would not be less than $50,000.

In addition, the provisions permitting cost-of-living adjustments to these dollar limits would be repealed.

S. 556 (Chafee)

S. 556 would reduce the dollar limits on contributions and benefits provided by qualified plans, tax-sheltered annuity programs, and SEPs. The dollar limits would be reduced by 15 percent in the case of any revenue enhancement year (defined to include any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989). Thus, for any such year, the dollar limit on annual additions to a defined contribution plan would be reduced from $30,000 to $25,500. The dollar limit on the annual benefit payable under a defined benefit pension plan commencing at age 62 would be reduced from $90,000 to $76,500. Conforming changes would be made to the limit on benefits commencing prior to age 62.

H.R. 1377 (Stark)

H.R. 1377 would reduce the dollar limits on contributions and benefits provided by qualified plans, tax-sheltered annuity programs, and SEPs. The dollar limits would be reduced by 20 percent in the case of any revenue enhancement year (defined to include any taxable year a portion of which falls within the period beginning January 1, 1986 and ending December 31, 1989). Thus, the dollar limit on annual additions to a defined contribution plan would be reduced from $30,000 to $24,000. The dollar limit on the annual benefit payable under a defined benefit pension plan commencing at age 62 would be reduced from $90,000 to $72,000. Conforming changes would be made to the limit on benefits commencing prior to age 62.

Reduced limits for key employees

It has also been suggested that it may be appropriate to repeal the combined plan limit for all plans, while further reducing the separate plan limits on contributions and benefits that may be provided for key employees.

Analysis

It has been suggested that consideration of the overall limit on benefits and contributions that can be provided under qualified plans and similar tax-favored arrangements requires evaluation of (1) what level of tax expenditure is appropriate for qualified plans; (2) what the appropriate limit should be with respect to any qualified plan; (3) whether it is appropriate to provide a higher, combined plan limit for those who participate in more than one plan; (4) at what rate, or over what period of service, a participant should be permitted to earn the maximum benefit; and (5) whether it is appropriate to provide an individual limit on total retirement savings.

Tax expenditures

Some have pointed out that the tax expenditure for qualified plans is the largest single item of tax expenditures. For fiscal year 1986, the tax expenditure for employer-maintained qualified plans (including Keogh plans) is estimated to be $56.8 billion and this expenditure is expected to increase to $88.9 billion for fiscal year 1990. For fiscal years 1986 through 1990, the total expenditure is estimated to be $359.8 billion. It is argued that, in the context of fundamental tax reform, it is necessary to reconsider whether a tax expenditure of this magnitude is appropriate.

On the other hand, others believe that the tax expenditure for qualified plans is justified because these plans provide retirement income. It has been argued that the cost of providing tax benefits under qualified plans is lower than the cost that would be incurred if those benefits were provided directly by the Federal government. Also, it has been argued that a curtailment of the incentives for establishing and maintaining qualified plans for higher-income individuals will result in a reduction of benefits for rank-and-file employees. Similarly, they argue that increases in the tax incentives could expand coverage and benefits provided for rank-and-file employees.

Separate limits

Although Congress has provided tax incentives to encourage employer-provided retirement benefits, it also restricts the tax benefits that an employee can derive from qualified plans of a particular employer. Those favoring a further reduction in the separate plan limits argue that the current dollar limits ($30,000 and $90,000, respectively) are unnecessarily generous, permitting tax-favored retirement savings far in excess of that needed to provide an adequate retirement income.

Opponents of any further reduction in the separate plan limits argue that these limits have already been substantially reduced by TEFRA, which lowered the dollar limits and suspended cost-of-living increases. They believe that the existing limits are a necessary incentive to foster employer-provided plans. If an employer cannot provide adequate benefits for highly compensated employees, there is less incentive to provide benefits for any employees. Some argue that it is necessary not only to maintain the existing limit but to increase these limits to reflect cost-of-living increases. If the current limits are appropriate in terms of 1985 income levels, they argue that it is equally appropriate to maintain those limits by adjusting them to reflect changing income levels.

Defined benefit plans versus defined contribution plans

Some believe that, in considering what separate plan limits are appropriate, it is necessary to consider the impact of the limits on the relative attractiveness of defined contribution and defined benefit plans. Some argue that defined benefit pension plans provide better overall retirement income security because the participants in defined benefit pension plans are protected against bad investment experience. Also, they point out that many defined benefit pension plans provide protection against inflation up to normal retirement age because the benefits provided are based on final average pay.

Some believe that defined benefit pension plans provide greater retirement security because they provide a more predictable level of benefits. They are concerned that the effect of legislation in recent years, such as the adoption of the rules relating to cash or deferred arrangements in 1978, has been to make defined contribution plans more attractive than defined benefit pension plans. Those favoring defined benefit plans argue that it may be appropriate to adjust the separate plan limits to provide greater incentives to maintain defined benefit plans. Some argue, for example, that the defined benefit dollar limit should remain $90,000 while the dollar limit on annual additions to a defined contribution plan should be reduced to $15,000 or $20,000.

However, those who favor defined contribution plans point out that defined benefit pension plans do not necessarily provide the best form of retirement savings for some employees, such as young, mobile employees. This group argues that the best approach to retirement income security is for employers to offer both types of plans to employees. For example, they believe that the trend toward adopting cash or deferred arrangements in recent years is a reflection of an employer shift toward providing more than one type of plan, rather than a shift from defined benefit pension plans to defined contribution plans. Accordingly, they argue that significantly reducing this trend by reducing limits on defined contribution plans will only hurt those younger, more mobile employees who would otherwise benefit.

Cost-of-living adjustments

Those favoring the suspension or repeal of cost-of-living adjustments argue that the present-law limits on overall contributions and benefits ($30,000 and $90,000 respectively) permit adequate, if not generous, levels of retirement income. They believe no further adjustments are needed.

Those opposing any further suspension or repeal of the cost-of-living adjustments to the overall limits argue that adjustments are needed to reflect the impact of inflation. Once realistic limits on allowable contributions and benefits have been set, they argue that adjustments are needed to prevent their significant erosion, in real dollar terms, by inflation over a long period of time. Without such adjustments, they suggest that as the general level of salaries increase over time, the portion of the work force affected by these limits would increase from a small minority to the majority of plan participants.

Some argue that cost-of-living adjustments can be accomplished by periodic Congressional action, if necessary. Others argue that ad hoc adjustments adversely affect an employer's ability to fund defined benefit pension plans on a level basis. They would prefer automatic adjustments at some periodic interval.

Combined plan limits

If an employee is covered by a defined benefit pension plan and a defined contribution plan of the same employer, in addition to the separate limits applicable to the plans, a limit is applied to the combination of plans.[42] The limit for combined plans, however, does not provide an aggregate cap on all tax-favored retirement benefits provided with respect to an individual by unrelated employers. Nor does it aggregate benefits payable from an individual retirement account with employer-provided benefits. Except in the case of employer contributions under a simplified employee pension, contributions to an IRA by (or with respect to) an individual are not coordinated with the overall limits.

Those favoring repeal of the combined plan limit argue that the existing limit creates significant administrative burdens by requiring an employer to make complicated calculations for each participant. They point out that the problem becomes severe in acquisition cases where an employee of an acquired company may have been employed in the past by the acquiring company. Of course, only highly compensated participants generally receive benefits at the maximum level so, in practice, many employers maintain the

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[42] In applying the limits, certain related employers are treated as a single employer (sec. 414(b), (c), (m), and (o)).

records and calculate the limits only with respect to those employees.

The Administration proposal would repeal the combined limit for plans that are not top heavy. Those who favor the Administration proposal point out that in a plan that is not top heavy, the cost of providing extraordinary benefits to highly compensated employees under qualified plans is generally prohibitive because the nondiscrimination rules require that benefits also be provided to numerous rank-and-file employees. They argue, therefore, that the combined limits are an unnecessary complication for plans that are not top heavy. They also point out that the amount of tax benefits provided for key employees under a plan that is not top heavy is a smaller portion of the total tax benefits under the plan than under a top heavy plan.

Reduced limits for key employees

Some who favor the Administration proposal believe that the mandatory lower limits for super top heavy plans should be retained or further reduced. They argue that no tax expenditure is justified with respect to such plans due to the minimal benefits provided to rank-and-file employees. They argue, therefore, that the combined plan limit should be retained for such plans or an alternative separate plan limit should be applied.

Others who are concerned with the complexity of the combined plan limit suggest that it may be more appropriate to repeal that limit for all plans, while lowering the separate defined benefit and defined contribution limits for key employees in top-heavy plans. For example, with respect to key employees in a top heavy plan, the separate dollar limit on annual additions could be reduced to $10,000 while the separate defined benefit limit could be reduced to $40,000. Alternatively, some suggest that the limits should fluctuate on a sliding scale based upon the percentage of benefits provided for the key employees.

Some suggest that a super top-heavy plan covering only one employee (e.g., the owner of the business) is essentially the same as an IRA. If one of the underlying purposes of the pension tax expenditure is to encourage coverage of low- or middle-income employees, they question why any tax benefits should be provided for a one-participant plan. Moreover, they question why an individual who is the owner of a business should be provided a more substantial tax subsidy than an individual whose employer does not maintain a qualified plan, whose tax-favored savings are limited to the $2,000 IRA contribution. Accordingly, some believe it is inappropriate to permit any more than $2,000 of deductible contributions in the case of a qualified plan covering only one participant and that the $2,000 limit should be coordinated with the IRA limit.

Others believe that the limits should not vary with the top heavy status of a plan. They argue that key employees of a business should not be subjected to lower limits merely because of the proportion of plan benefits provided for those employees. In addition, they point out that if some combined limits are retained for top heavy plans, then plan provisions imposing the limits would be necessary in almost all plans because they would be required to become immediately effective if any plan becomes top heavy.

Others suggest that the complexity caused by the combined plan limit comes not from including a provision in the document, but from operating in compliance with the limit.

Those arguing against any reduction of the existing limits note that the plan qualification rules are designed to encourage an employer to provide reasonable benefits for a fair cross section of employees. They point out that an employer wishing to provide retirement benefits primarily for highly compensated employees necessarily compares the tax advantages of providing such benefits through a qualified plan with the cost of providing benefits only for nonhighly compensated employees through a nonqualified deferred compensation arrangement. They argue that reduction of the overall limits on benefits that can be provided for highly compensated employees makes the use of a qualified plan less desirable and may cause plan termination.

Others suggest that some of the plans that may terminate are those that provide benefits almost exclusively for highly compensated employees. They argue that such terminations will create a more equitable allocation of the tax expenditures associated with qualified plans and, therefore, should not be viewed as a negative consequence of reducing the overall limits.

Employee contributions

Under present law, all employer contributions are taken into account in applying the limit on annual additions. On the other hand, employee contributions that are not more than six percent of pay are disregarded entirely. Under the Code, employee contributions taken into account are limited to employee contributions in excess of six percent of pay or one-half of the contributions, whichever is less.

Proponents of the Administration proposal to include one-half of all employee contributions argue that the rules do not properly limit tax benefits to a reasonable level if they exclude the first six percent of employee contributions. They believe that the exclusion of one-half of these contributions appropriately reflects the reduced tax benefits attributable to employee contributions (the investment yield on these contributions is not taxed until it is distributed but the contributions are not deductible). They argue, therefore, that it is inappropriate to exclude more than one-half of employee contributions.

Some argue that the most valuable benefit provided by qualified plans is long term tax-deferred growth. Because employee contributions also receive the benefit of tax-deferred growth, they suggest that limits lower than the Administration proposal may be appropriate. They believe that present law, by disregarding some amount of employee contributions, provides overly generous limits which favor employee contributions over employer contributions.

For example, for an employee earning $120,000, employer contributions are limited to the lesser of 25 percent of compensation or $30,000. Alternatively, if that employee participated in an employee-pay all plan, the overall limits would permit the employee to contribute 50 percent or $60,000.[42a] Of the $60,000 contribution, the lesser of one half the contributions ($30,000) or those contributions in excess of six percent ($52,800) is treated as an annual addition. For this employee, those favoring a reduced limit on employee contributions point out that the Administration proposal would not change this result. This group argues that, because long term tax-deferred growth is the most valuable benefit derived from qualified plans, it is appropriate to take all employee contributions into account.

Opponents of the Administration proposal suggest that the present-law rules concerning employee contributions provide appropriate limits. They note that employee contributions receive only one of two tax benefits accorded qualified plans—tax deferred growth. Because employee contributions, unlike employer contributions, do not receive the benefit of a current deduction, they argue that it would be inappropriate to count those contributions fully in applying the limits. They note also that, under present law, no limits are imposed on amounts that may grow, tax-free, in an annuity contract. They question why a stricter rule should be applied to qualified plans.

The Administration proposal would limit the amount of earnings that can accumulate tax-free (the inside build-up) in certain deferred annuity contracts. Some of those who favor that proposal suggest that a similar limit should apply to amounts eligible for tax-deferred growth under a qualified plan.

Opponents of the Administration proposal argue that the present rules reduce the administrative burden on plans by eliminating the need for special treatment of what they regard as a de minimis level of employee contributions. They believe that a de minimis rule is justified by the relatively lower tax benefits provided for employee contributions at this level.

Some of those who support the continuation of a de minimis exclusion on the basis of administrative burden believe that there is no need to permit the de minimis relief if contributions exceed the threshold. Thus, they argue, it may be appropriate to disregard all contributions not in excess of six percent of compensation, but to take 50 percent or perhaps 100 percent of all contributions into account if total contributions exceed the de minimis threshold.

Still others favoring a de minimis rule question whether six percent of compensation constitutes the appropriate threshold. They point out that, if unlimited compensation is taken into account, this rule would permit de minimis contributions of $6,000 (based on $100,000 of compensation), $12,000 (based on $200,000 of compensation), or $30,000 (based on compensation of $500,000 or more). They believe a lower percentage limit (some suggest two percent) or a flat dollar limit (perhaps $2,000) should be applied as a de minimis threshold. Employee contributions less than the threshold would be disregarded in full, but all contributions in excess of that amount would be treated as annual additions.

[42a] In general, the rules prohibiting discrimination in favor of officers, shareholders, or highly compensated employees would not affect the ability of an employee to made contributions to a qualified plan up to the lesser of 50 percent of compensation or $30,000. (For a description of the issues relating to the treatment of employee contributions under qualified plans, see Part II, C., Employer Matching Contributions.)

Imposition of an individual limit

In general

Some believe that present law is deficient because it sets a limit on the level of benefits that can be provided under plans of a particular employer for an employee, but does not limit the aggregate level of benefits that may be provided with respect to an individual under plans of unrelated employers. They believe that present law has encouraged some individuals to change employment in order to maximize retirement benefits and has led to creative tax planning by others. They point out that some professionals have been able to arrange participation in plans of employers that are technically unrelated but that are, in reality, parts of, or continuations of, a single trade or business. They argue that an appropriate limit should apply at the employer level and the individual level.

In determining the appropriate level of tax-favored retirement benefits, it is necessary to determine whether it is more appropriate to set a limit on the tax-favored benefits that may be provided by any employer, or on the tax-favored benefits that any individual may receive.

Those favoring some type of individual limit argue that the original purpose of the overall limit, i.e., preventing the accumulation of pensions "swollen completely out of proportion to the reasonable needs of individuals for a dignified level of retirement income,"[43] is achieved only through the adoption of an individual limit. If the tax incentives are intended to encourage employers to provide reasonable levels of retirement income, they argue that there is no reason to allow an individual to receive multiple maximum benefits from several unrelated employers far in excess of the amount any single employer could provide, as well as tax-favored individual retirement savings through an IRA. They believe that this is particularly inappropriate in the case of professional employees who often control their own professional corporations, creating successive "employer" entities to secure multiple maximum benefits. They also argue that present law provides an incentive for an employee who has earned the maximum allowed by the Code under a qualified plan to find employment elsewhere so that additional benefits can be obtained.

Those opposing adoption of some type of individual limit argue that compliance with the limit on an employer level would cause administrative complexity. They note that no employer should be forced to monitor an employee's entire working career merely to ascertain permitted benefit levels.

Some of those favoring adoption of some type of individual limit agree that it would be difficult to monitor accumulated savings under plans maintained by unrelated employers. Some suggest that it would be administratively difficult to require that each employer verify previously earned retirement benefits, monitor individual retirement account savings, and accurately predict what future benefits an employee might earn through subsequent employers before establishing the level of benefits it could provide. However, they

[43] H. Rpt. 93-779, 93rd Cong., 2d Sess. 111 (1984).

argue that an individual limit could be implemented on a participant level, as under the Administration proposal, by measuring actual benefits received upon retirement.

Recapture of tax benefits

Some who support an individual limit believe that it might be provided through an excise tax on excess benefits, as provided in the Administration proposal. They argue that, to the extent aggregate annual benefits paid by tax-favored savings arrangements exceed a stipulated level (e.g., $112,500 under the Administration proposal), an excise tax (designed to recapture the tax benefits derived from excessive deferrals) could be imposed. Some argue that $112,500 is too high a threshold and that no individual needs tax subsidies to ensure benefits of $112,500 per year upon retirement.

Many who favor the excise tax approach believe it is particularly important to reflect the time value of money. Accordingly, they argue that an employee who obtains excessive benefits may be able to benefit from the tax-free compounding of income on plan assets acquired with deductible employer contributions (as well as nondeductible employee contributions). Some believe that an excise tax could appropriately be used to recoup a measure of the tax benefits accorded to savings set aside for retirement where the savings are used to provide retirement benefits in excess of a stipulated level. Some who support an excise tax believe that the 10-percent tax suggested by the Administration proposal is sufficient to recapture the benefits of tax deferral. Others argue that, in view of the possibly extended deferral period (of up to 40 years), it is necessary to impose a higher excise tax, either at a flat rate (e.g., 20 percent) or pursuant to a sliding scale based on the length of the deferral, the actual yield, or some combination of similar factors. For example, the tax rate could be based on the relationship of earnings to total plan assets.

On the other hand, some assert that, especially for defined contribution plans and IRAs, the excise tax is essentially a tax on success. They suggest it unfairly penalizes plans with favorable investment experience.

Proponents argue that the imposition of an annual limit would further discourage consumption of lump sum benefits. Those who believe retirement savings should be accumulated until retirement argue that this proposal may enhance benefit security by encouraging rollovers.

Separate plan limits

Some believe that it may also be appropriate to coordinate evaluation of the individual limit with decisions as to the permitted separate plan limit and the combined plan limit. It has been suggested that imposition of an individual limit, enforced through some sort of recapture tax, may make separate plan limits unnecessary.

Others argue that if the combined plan limit is repealed for all plans and separate dollar limits of $90,000 and $30,000 are retained for defined benefit and defined contribution plans, a higher excise tax may be needed, both to deter excessive accumulations and to overcome the revenue losses generated by repealing the combined plan limit. They note that permitting larger contributions creates the possibilities of even more generous treatment than present law, particularly if the excise tax is set at a low rate. This group opposes elimination of the separate plan limits, because they believe that these limits remain necessary to limit employer contributions (and deductions) and to provide a cap on amounts that may be accumulated by any one employer.

Others argue that, in connection with repeal of the combined plan limit, the separate plan limits should be reduced so that it is less likely that any individual could receive excess benefits, perhaps making it unnecessary to impose a recapture tax on total distributions made with respect to an individual. They suggest that this approach would be preferable to the recapture tax because it would be easier to administer.

Still others argue that, regardless of the decisions made with respect to the dollar or combined plan limits, an individual limit is needed to discourage taxpayers from creating successive employer entities to earn multiple maximum benefits. Those opposed to imposition of an individual limit argue, however, that such abuses could be directly discouraged by treating certain successive employers as a single employer in applying the separate plan limits. They believe that professionals and others would be precluded under such a rule from manipulating the separate plan limits, and that other individuals would not be subject to the administrative burden of an individual limit.

Period of participation

The overall limits provided by the Code with respect to defined benefit pension plans include a feature designed to "prevent a situation where an individual might receive an extremely high pension, even though he had only a few years of active service under a plan."[44] To prevent this abuse the Code provides a minimum service requirement applicable to a defined benefit pension plan. Under the minimum service requirement, no participant with less than 10 years of service with the employer is permitted to receive the full $90,000 benefit. For this purpose, all years of service, including periods before an individual participated in the plan, may be taken into account.

Those favoring the Administration proposal—reducing the overall limit for those with fewer than 10 years of participation—argue that, under present law, it is possible for a participant with as little as one year of participation to earn the maximum benefit. They argue that this may continue to present a potential for denying benefits for other employees, especially in the context of a small employer. They note, for example, that a business owner could defer adoption of a plan until the owners or key employees are close to retirement age.

Because pre-participation service counts for purposes of determining the limit, an owner with at least 10 years of service (including pre-participation service) and average compensation of at least $90,000 could earn an annual benefit of as much as $90,000, even

[44] H. Rpt. 93-779, 93rd Cong., 2nd Sess. 119 (1974).

though the plan was maintained for only a few years. If the plan then terminated, it is argued, other participants may not have sufficient service to accrue significant benefits. If, however, the owner was required to maintain the plan for at least 10 years (because the maximum benefit were phased in based upon years of participation, rather than service), they argue that other employees would be entitled to more significant benefits. Some argue that it may be appropriate to phase in the maximum benefit over a period longer than 10 years.

Those opposing the Administration proposal argue that it disadvantages smaller businesses, particularly start-up businesses, that may not be financially able to establish a plan during the early years of business operation. They also note that many other provisions of existing law address the inequities arising in situations involving short-lived plans designed primarily to provide benefits for key employees. In particular, they point to the rule that requires a qualified plan to be a permanent program, the rules restricting benefits payable to the 25 highest paid employees in the event of an early termination, the integration guidelines, and the top-heavy minimum benefit requirements. They argue that these provisions are adequate to deal with the concerns over late establishment of plans. In addition, they point out that the benefit of tax deferral is reduced if a plan is established later.

Both proponents and opponents of the Administration proposal agree that, if the applicable limit is reduced to reflect fewer than ten years of participation, the Administration proposal to protect lower-paid, long-service employees is very important. For those employees, reduction of the percentage limits may be particularly inappropriate. Some suggest, therefore, that it would be possible to reduce the percentage limits based on years of service while reducing only the dollar limits based on years of participation. This would permit long-service, lower-paid employees to receive more appropriate benefits.

Tax-sheltered annuities

Proponents of the Administration proposal to repeal the special limits applicable to tax-sheltered annuities argue that those higher limits are particularly inappropriate because tax-sheltered annuities need not satisfy coverage or nondiscrimination rules. They question why such programs should be able to provide greater benefits than qualified plans that are required to provide nondiscriminatory benefits to a significant percentage of employees.

Opponents of the Administration proposal argue that tax-sheltered annuities, designed to meet special needs of tax-exempt employers, have been permitted since 1942. Since that time, these programs have become the primary retirement plan for most educational organizations and many churches. They argue that it is inappropriate to disrupt these programs after 43 years, undermining the expectations of sponsoring employers and covered employees.

Some opponents also note that it may be appropriate to permit additional flexibility to tax-exempt employers because they do not receive the tax benefits afforded employer deductions. Others recognize that the value of tax-deferred growth, which is a benefit provided to tax-exempt employers, may represent the most significant tax benefit provided to qualified plans or tax-sheltered annuities.

Opponents of the proposal also argue that the special catch-up elections are necessary to provide adequate retirement income for employees of certain tax-exempt organizations. They argue that relief is particularly needed under a defined contribution plan, which limits annual contributions based on current compensation.

For example, they suggest that employees of a church or educational institution are generally unable to make significant contributions during the earlier years of their career due to lower compensation levels. The existing catch-up provisions are designed to permit those employees to make greater contributions in later years when they have increased compensation or lower current consumption needs. They point, for example, to foreign missionaries, who may receive very low compensation while working abroad in the early part of their career. If the present-law catch-up provisions are repealed, that lowered compensation level would affect not only current income, but also retirement savings (because employer contributions are limited to a percentage of that lower compensation).

Proponents of the Administation proposal suggest that these arguments—that compensation (and an employee's ability to save) generally increase over the course of an employee's career—apply equally to all employees, not merely those of tax-exempt organizations. They also point out that this problem can be resolved if an employer provides either career average or final average pay benefits through a defined benefit pension plan. They are not persuaded by arguments that tax-exempt entities should be specially insulated from the commitments of defined benefit pension plans and, accordingly, they suggest there is no need to permit this flexibility in a defined contribution plan.

In the case of educational institutions, where professors are particularly mobile, some argue that a defined benefit pension plan may not provide the best retirement savings vehicle for mobile employees, especially if the plan provided deferred vesting. Opponents of the proposal argue that the portability afforded by tax-sheltered annuities permits a mobile employee to move from institution to institution without losing benefits. They argue that this portability is further enhanced by immediate vesting.

Opponents of the Administration proposal also suggest that an employer's ability to make additional contributions in the year of termination enables tax-exempt institutions, especially colleges and universities, to encourage early retirement for older professors unable to keep pace with ongoing academic challenges. Also, educational organizations argue that the university tenure system makes it especially difficult to force a professor to retire. They argue that the special catch-up elections are needed to permit institutions to maintain a teaching staff and to provide promotion opportunities for younger professors.

Proponents note again that problems involving older workers and the appropriate level of early retirement incentives are not unique to tax-exempt entities. Arguably, these needs can be met through the adoption of a defined benefit pension plan.

B. Deductions for Contributions to Qualified Plans

Present Law and Background

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. Under the Code, if a contribution for a year exceeds the deduction limits, then the excess generally may be deducted in succeeding years as a carryover. Deductions are not 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

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 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.[45]

(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

[45] 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 amortization 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. Contributions may be reduced or eliminated under a plan that has reached the full funding limitation (see *Minimum funding*, below).

remaining unfunded cost with respect to any three 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 five 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 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.

Certain excess contributions

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

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 being maintained for the exclusive benefit of employees.

Actuarial assumptions

Because an employer who maintains a qualified defined benefit pension plan is required to fund on a level basis the cost of projected benefits, it is necessary to make certain assumptions with respect to the level of benefits that will actually be provided by the plan. The assumptions necessarily take into account 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 actuarial 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 30-year period. Actuarial gains and losses (the difference between estimated experience and actual experience) are taken into account, through reductions in funding, over a period of 15 years.a

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 amount required under the minimum funding standard is the contribution rate specified by the plan.

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 plan 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.

Although the Code generally limits deductions for a combination of plans to a percentage of the employees' compensation, if the minimum contribution required for a defined benefit pension plan under the funding standard exceeds that percentage, the contribution is deductible without regard to the limit. In such a case, no deduction would be allowed for a contribution to a profit-sharing or stock bonus plan.

Discriminatory funding

In some cases, an employer may provide separate pension plans for distinct groups of employees. Under these circumstances, one or more of the plans may provide greater benefits for higher-paid employees than those provided to rank-and-file employees by another plan. If one of the plans benefiting more highly paid employees were tested separately, it would fail to meet the coverage requirements of the Code. Accordingly, the rules permit two or more plans with comparable benefits to be tested as a single plan for purposes of the coverage tests. If an employer designates two or more plans as a single plan for coverage purposes, they will be tested together. For example, an employer could designate that a plan for highly paid employees and a plan for rank-and-file employees are to be tested for coverage as if they were a single plan.

Administration Proposal

Profit-sharing and stock bonus plans

The proposal would modify the 15 percent of compensation limit applicable to profit-sharing or stock bonus plans to apply on an individual, rather than an aggregate, basis. Thus, the deductible contribution with respect to a particular employee could not exceed 15 percent of that employee's compensation from the employer. Accordingly, the unused deduction with respect to a low-paid employee could not be used to permit greater deductions with respect to a high-paid employee.

Under the proposal, no carryforward would be permitted for unused deduction limits except under certain "retirement type" profit-sharing plans. A profit-sharing plan would be treated as a "retirement-type" plan with respect to an individual for a year only if the following conditions are satisfied for such year: (1) the individual is an active participant under the plan; (2) the individual is not a participant in any other qualified profit-sharing or stock bonus plan maintained by the employer; (3) contributions on behalf of the individual are based on a contribution or allocation formula using a reasonable year-of-service factor; (4) employer-derived benefits attributable to the year and to any other year for which the plan was a "retirement-type" plan are not available, either by distribution or loan, before separation from service, death, or disability; and (5) the plan is not top-heavy.

Combinations of pension and other plans

The 25-percent of aggregate compensation limit would be extended to all combinations of defined benefit and defined contribution plans. Under the proposal, for example, the limit would apply if an employer maintains a defined benefit pension plan and a money purchase pension plan. In no event, however, would the employer's deduction for the year be less than the amount needed to meet the minimum funding requirement applicable to the defined benefit pension plan.

Nondeductible contributions

Employer contributions in excess of the deductible limits would be subject to a 10-percent annual nondeductible excise tax until the excess is eliminated.

Other Proposals

1984 Treasury Report

The Treasury report was substantially similar to the Administration proposal, except that the report would not allow a carryforward of unused deduction limitations under profit-sharing plans providing retirement-type benefits. The excise tax on nondeductible employer contributions would have been six percent under the proposal.

S. 409 and H.R. 800 (Bradley-Gephardt)

The overall dollar limit on annual additions to defined contribution plans (profit-sharing or stock bonus plans, and money purchase pension plans) would be reduced (see Overall Limits on Contributions and Benefits, above). The dollar limit on the annual addition under a defined contribution plan would be reduced from $30,000 to $20,000. The dollar limit on annual benefit under a defined benefit plan beginning at age 62 would be reduced from

$90,000 to $60,000, and the limit at age 55 would be reduced from $75,000 to $50,000. In addition, the cost-of-living adjustment to those limits would generally be repealed. These reduced limitations would be reflected in reduced deductions.

H.R. 1377 (Stark)

H.R. 1377 would reduce the dollar limitations on contributions and benefits under qualified plans by 20 percent in the case of any "revenue enhancement year." The reduced limitations would be reflected in reduced deductions. A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989. For any such years, the dollar limit on annual additions to a defined contribution plan would be reduced from $30,000 to $24,000. The dollar limit on the annual benefit payable under a defined benefit pension plan commencing at age 62 would be reduced from $90,000 to $72,000. Conforming changes would be made to the limit on benefits commencing prior to age 62.

S. 556 (Chafee)

H.R. 1377 would reduce the dollar limitations on contributions and benefits under qualified plans by 15 percent in the case of any "revenue enhancement year." The reduced limitations would be reflected in reduced deductions. A revenue enhancement year is any taxable year a portion of which falls within the period beginning January 1, 1986, and ending December 31, 1989. For any such year, the dollar limit on annual additions to a defined contribution plan would be reduced from $30,000 to $25,000. The dollar limit on the annual benefit payable under a defined benefit pension plan commencing at age 62 would be reduced from $90,000 to $76,500. Conforming changes would be made to the limit on benefits commencing prior to age 62.

Overall limit on deductions

Some have suggested that the annual deduction under a defined benefit pension plan should be limited to the annual amount needed to spread the liabilities under the plan over a period of 10 years. The limit would apply even though contributions are required under the minimum funding standard.

Discriminatory funding

In the case of a defined benefit pension plan that meets the qualification requirements of the Code only because of comparability with another qualified defined benefit pension plan, some have suggested that no deduction should be allowed for a contribution to the plan if it is better funded than the plan on which it depends.

Actuarial assumptions

It has been suggested that, for purposes of computing an employer's deduction for a contribution to qualified defined benefit plan, certain actuarial assumptions that have a material effect on the measurement of liabilities under the plan, standing alone, should be reasonable. For example, separate reasonableness standards have been suggested with respect to actuarial assumptions regarding anticipated investment yield and those regarding the marital status of plan participants.

Analysis

Profit-sharing and stock bonus plans

The 15-percent limit on deductible employer contributions to a profit-sharing or stock bonus plan provided by present law applies on an aggregate, rather than on a per-participant, basis. Because the test is applied on an aggregate basis, the deduction limits unused with respect to a particular participant may, in effect, be used for another participant. In the case of a plan that is integrated with social security, employer contributions are a greater percentage of the compensation of high-paid participants than of low-paid participants. Under present law, the unused deduction limits for the low-paid participants permit deductible contributions for high-paid participants to exceed 15 percent of their compensation.

Those who support the Administration proposal believe that it would tend to reduce the incentives provided by present law to allocate a greater proportion of employer contributions to more highly compensated employees, by, for example, integrating contributions with social security.

Some who believe that the deduction rules should not provide an incentive to integrate a plan with social security contributions have suggested that, in the case of an integrated plan, the deduction limits should be reduced. They suggest that the deduction limits should be applied to the sum of employer contributions to the plan and the employer share of social security taxes paid with respect to plan participants that is taken into account under the plan. Others have suggested that the level of compensation taken into account in applying the deduction limit should be reduced to reflect the extent of integration.

Those who oppose reduction of the deduction limits to reflect integration argue that the issue of whether qualified plans should be integrated with social security is more appropriately addressed under the plan qualification rules, rather than the deduction rules. See the discussion of integration under Part III. A. 3., above. They argue that new deduction rules will add unnecessary complexity to the computation of deductions.

Some who oppose the proposal have pointed out that, under profit-sharing plans, the rate of an employer's contribution with respect to an employee may be weighted to years of service (i.e., contributions allocated to a participant's account increase as the participant's years of service increase) so that long-service employees are entitled to a greater contribution, as a percentage of their compensation, than other employees. They are concerned that the deduction limit proposed by the Administration could reduce contributions for employees who have provided the greatest service.

Some pension experts have proposed that the 25-percent deduction limit should be repealed, rather than extended, because it discourages savings and complicates the administration of plans. They also argue that the overall limit on contributions and benefits prevents excessive deductions. Those who oppose repeal of the limit argue that the 25-percent limit tends to force employers to establish qualified plans earlier and maintain them for a longer period of time. This, they assert, will result in rank-and-file employees being covered by a plan for longer period of time.

Credit carryovers

Under the Administration proposal, if employer contributions to a profit-sharing or stock bonus plan for a particular year were below the deduction limit for the year, the excess deduction limit could not be carried forward unless the plan was a retirement-type plan. Those who favor the proposal argue that, although the availability of deduction credit carryforwards should be preserved as an incentive for retirement-type plans, it is inappropriate to permit credit carryforwards in savings plans.

It has been suggested, however, that the availability of deduction carryovers under a plan should not be based on whether the benefits under that plan are more likely to be used for retirement. Those who oppose any restrictions on carryovers assert that the contribution and credit carryforward provisions permit employers to provide a reasonable level of contributions over an extended period of time despite annual fluctuations in cash flow or profits. Repeal or restriction of the credit carryforward, they argue, may harm employers, particularly small businesses, that are profitable over a period of years but that experience periodic losses.

Combinations of pension and other plans

Proponents of the Administration proposal argue that applying a 25-percent of aggregate compensation limit for all combinations of defined benefit and defined contribution plans would tend to prevent taxpayers from avoiding the cost of providing benefits to rank-and-file employees by delaying the establishment of a plan until those employees have separated from service. They believe that the limitation would encourage the early establishment of plans and orderly funding. Those who favor the Administration proposal also point out that it would not disallow deductions for contributions to a defined benefit pension plan to the extent required under the minimum funding standard.

Others argue that the proposed limit would adversely affect a small employer whose capital was reinvested in the business or who otherwise did not have funds available for retirement savings in earlier years.

Similarly, some believe that the proposed limit could adversely affect an employer whose workforce has been reduced because of changes in economic circumstances. In such a case, the plan may have incurred unfunded obligations while the workforce was large, expecting that the obligations would be funded in the future. If the workforce declines in the future, so that the 25-percent limit is applied to a smaller compensation base, then the employer might find itself unable to continue any plan but the defined benefit pension plan if it is to meet its obligations to retirees.

Similarly, it is argued that the 25-percent limit would tend to discourage employers from hiring older workers because the costs for these employees under a defined benefit pension plan are greater than for other employees and would tend to bring the employer closer to the 25-percent limit. In such a case, the costs for older workers could reduce the level of deductible contributions allowed with respect to another plan of the employer. Those who favor the proposal point out, however, that present labor law generally, the Age Discrimination in Employment Act, forbids discrimination in the employment of older workers.

Some object to the proposal because it could deny a deduction for employer contributions to a money purchase pension plan that are required by the minimum funding standard. Proponents point out, however, that the contribution formula for a money purchase pension plan could be amended to preclude this result.

Nondeductible contributions

Those who favor a nondeductible annual 10-percent tax on accumulated excess contributions argue that it would tend to reduce the benefit of tax deferral resulting from excess contributions. They believe that it is particularly important to reflect the time value of money. Accordingly, they argue that no employer should be permitted to benefit from the tax-free compounding of income on plan assets acquired with excess employer contributions. Some argue that it is appropriate to recoup those tax benefits by imposing an excise tax. Those who support the Administration proposal believe that although the tax would not necessarily measure the extent of the tax benefits arising from excess contributions, it would provide a reasonable approximation without the complexity required by an exact computation.

Others argue that the tax could reduce the security of benefits under a defined benefit pension plan by discouraging conservative funding practices. In addition, those who oppose the proposal argue that the 10-percent rate could completely offset the investment yield under a plan with respect to excess contributions.

Reduction of limits

(For a discussion of the effects of a reduction in the overall limits on contributions and benefits under qualified plans, see Part V. A. Overall Limits on Contributions and Benefits, above.)

Overall limit on deductions

It has been proposed that deductions for employer contributions to a defined benefit pension plan should not be allowed at a rate more rapid than the rate at which they would be allowed if all costs (including projected liabilities) under the plan were spread evenly over a 10-year period. Those who support this proposal argue that present law permits some employers, often professional corporations, to claim inappropriate deductions and excessive tax-free accumulations by artificially accelerating the rate at which benefits accrue and then using the minimum funding requirement as a justification for immediate contributions. In some instances, employers have attempted to claim deductions for fully funding a plan in a period as short as one year. Proponents argue that it is appropriate to require more level funding over a period of at least 10 years.

Those who oppose the proposal point out that it creates an unnecessary tension between the deduction rules and the minimum funding requirements, which provide an important measure of benefit security for employee benefits. They argue that deductions should be allowed for employer contributions allowed under the minimum funding standard. Some also argue that it is more appropriate to address the immediate accrual problems through the qualification rules. (For a discussion of one proposal to phase in benefit levels over years of participation, see V. A. Overall Limits on Contributions and Benefits.)

Discriminatory funding

(For a discussion of the effects of a reduction in deductions based upon discriminatory funding, see Part III. A. 2. Benefits and Contributions, above.)

Actuarial assumptions

Those who favor a requirement that certain key actuarial assumptions should be reasonable, standing alone, argue that present law has permitted actuaries to overstate plan liabilities, thereby increasing employer contributions and deductions. They point to cases in which plans are earning more than nine percent on their investments, but are deducting contributions based on a five-percent investment yield. Because the interest assumption is generally a key element in determining the level of funding under a plan (because lowering the assumed interest rate increases required distributions), they argue that the use of unreasonably low interest assumptions can result in very significant increases in the level of deductions under a plan. Some also argue that it is appropriate to require 10 year amortization of experience losses, as well as experience gains, in calculating the maximum deductible contribution limit to a defined benefit pension plan.

In addition, those favoring the requirement that assumptions be reasonable, standing alone, point to cases in which required contributions and deductions are artificially increased by manipulating assumptions as to marital status. For example, there are situations in which the owner (and sole employee) of a professional corporation is unmarried but in which funding of the corporation's plan is made on the assumptions that (1) the employee will be married when benefits commence, (2) the spouse will be considerably younger than the employee, (3) the spouse will outlive the employee, and (4) the plan will provide survivor benefits to that spouse for an extended period. They argue that using assumptions of this nature to artificially increase contributions and deductions is an abusive practice that should be curtailed. They believe that if interest and marital status assumptions were required to be reasonable, standing alone, the rules could be more readily enforced. In addition, the requirement would not adversely affect plans that accurately reflect actual investment yield, marital status, etc..

Those who oppose separate standards for specific assumptions (e.g. interest and marital status assumptions) argue that the present standard requiring that assumptions be reasonable in the aggregate is adequate. They believe that problems peculiar to professional corporations should not result in rules adversely affecting other employers and that the solution to abusive assumptions is stronger enforcement of present law.

C. Asset Reversions from Terminated Plans

Present Law and Background

In general

A qualified plan must be for the exclusive benefit of employees (sec. 401(a)). Generally, prior to the satisfaction of all liabilities with respect to employees and their beneficiaries, the assets held under a qualified plan may not be used for, or diverted to, purposes other than the exclusive benefit of employees (sec. 401(a)(2)). However, 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 certain qualified defined benefit pension plans are guaranteed (within limits) by the Pension Benefit Guaranty Corporation (PBGC), (a Federal corporation within the Department of Labor).

Surplus arising from actuarial error

The Code and ERISA permit an employer to receive a reversion of assets from a terminated defined benefit pension plan provided 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.

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, the 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.

In funding a plan, assumptions are made regarding the anticipated rate of investment earnings. Because actual experience often 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, which are taken into account over a 30-year period.

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 amortized prior to the date of termination. The resulting reduction in liabilities 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 addition, some terminated defined benefit pension plans have realized substantial experience gains in recent years 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 at any time prior to the satisfaction of the plan's liabilities with respect to employees and their beneficiaries. Upon termination of a qualified defined pension plan, all benefits provided by the plan are required to be vested. After these liabilities are satisfied, remaining assets may revert to the employer.

Spin-off termination.—In some cases, reversions have been permitted after a plan has been divided into two or more 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 in pay status 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 spin-off termination, the excess assets are typically allocated entirely to the plan for employees in pay status. If that plan buys annuity contracts to satisfy 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, the employer may terminate a defined benefit pension plan, take a reversion, and then establish a new plan. The new plan may be another defined benefit pension plan or it may be another type of program. Under some termination-reestablishment arrangements, the new program is a defined benefit pension plan with the same benefit formula as the terminated plan, except that benefits under the new plan are reduced or offset 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.—Under present law, the extent to which a defined benefit pension plan that was overfunded, on a termination basis, can transfer excess assets directly to a qualified defined contribution plan of the same employer is uncertain. Because such a 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, diverting assets from the exclusive benefit of participants. In at least one instance, the Internal Revenue Service recently issued a general information letter suggesting that the amount transferred from a defined benefit pension plan to a defined contribution plan was not includible in the gross income of the employer and was not deductible by the employer. The Internal Revenue Service has indicated that it is reexamining the issues raised in the general information letter.

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 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 spin-off termination or a termination-reestablishment transaction only if certain conditions are met.

A spin-off 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 spin-off 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 spin-off termination or termination-reestablishment transaction) from engaging in another transaction for at least 15 years.

Tax treatment of reversions

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.

Employer securities

ERISA provides a limit on the proportion of plan assets that may be invested in securities or real property of a related employer. Under ERISA, in the case of a defined benefit pension plan or money purchase pension plan, holdings of qualifying employer securities generally may not exceed 10 percent of plan assets. Certain defined contribution plans may hold greater amounts of qualifying employer securities provided the plan specifies the extent of such investments.

Administration Proposal

The proposal would impose a nondeductible excise tax equal to 10 percent of the plan funds reverting to the employer upon plan termination to recapture some portion of the tax advantages provided with respect to such funds. This tax would be nondeductible and could not be offset by losses or other deductions, or credits.

Other Proposals

H.R. 2701 (Roybal)

Reversions

The bill would limit the amount of assets that could revert to an employer upon plan termination. In the absence of a business necessity (bankruptcy, insolvency, or other business hardship) for the termination of a defined benefit pension plan, excess assets first would be allocated to plan participants who are within five years of the plan's normal retirement age, and to participants who have retired under the plan. If the plan has excess assets after the required allocations to those employees, any remaining surplus could revert to the employer, subject to a 10-percent excise tax.

Employer securities

The bill also would reduce the permitted level of employer securities that may be held by a pension plan from 10 percent to five percent. In addition, the bill would permit only the acquisition of securities that have no features of indebtedness or loans.

Spin-off terminations

It has been suggested that, in addition to the Administration proposal, it might be appropriate to require assets to be allocated in proportion to liabilities in the event of a spinoff of a plan.

Moratorium on reversions

Some have proposed a moratorium on reversions. During the moratorium, no assets could be reverted to the employer.

Interest rate on certain employee contributions

The minimum interest rate required to be provided by a plan with respect to employee contributions could be increased from 5 percent to a rate that more accurately reflects the earnings on a portfolio of long-term investments.

Analysis

Excise tax on reversions

Proponents of the Administration proposal to impose an excise tax on reversions point out that present law does not include features specifically designed to reflect the time value of money in the tax treatment of reversions. They believe that an excise tax could appropriately be used to recoup a measure of the tax benefits accorded to savings set aside for retirement where the savings are not used to provide retirement benefits.

Some who support an excise tax believe that the 10-percent tax suggested by the Administration proposal is sufficient to recapture the benefits of tax deferral; others argue that, in view of the possible extended deferral period, it is necessary to impose a higher excise tax either at a flat rate (e.g., 20 percent) or pursuant to a sliding scale based upon the length of the deferral, the actual yield, or some combination of similar factors. For example, some argue that the level of the excise tax should be based on the ratio of contributions to total plan assets.

On the other hand, opponents of the excise tax proposal argue that assets should not be regarded as surplus merely because they are not ultimately needed to pay benefits. They believe that these assets provide an important safeguard against the possibility that the plan will suffer adverse experience. Accordingly, they argue that assets used to provide benefit security should not be considered as surplus and should not be subject to an additional tax. In addition, opponents of the tax argue that it would not accurately measure the extent of the tax benefit derived by an employer with respect to assets not used to pay benefits.

Inflation adjustments

Some have suggested that no reversion should be permitted unless the amount of the reversion is first reduced to permit benefit adjustments sufficient to fulfill the reasonable expectations of employees who believe that the employer's pension plan will provide them with adequate retirement income. They contend that employer contributions to a qualified plan represent amounts employees have foregone in current wages in exchange for anticipated retirement benefits. Therefore, they propose that amounts contributed to a defined benefit pension plan by an employer should not be returned to the employer until provision has been made for some or all of the benefit increases that may have resulted from inflation. Some argue that it may be appropriate to permit a reversion only if the employer uses the amount of the reversion to establish an Employee Stock Ownership Plan.

In particular, some proponents point out that defined benefit pension plans often provide automatic or ad hoc adjustments for inflation occurring before separation from service and that some plans provide for inflation adjustments after retirement or separation from service. They argue that, before excess assets under a plan revert to an employer, the plan should provide post-termination inflation adjustments to reflect the reasonable expectations of employees unless the plan is terminated on account of a business necessity.

Those opposed to this approach point out that employers can generally obtain the use of excess assets over a period of time by reducing the rate at which the plan is funded. They argue that, over a period of time, such an approach is more likely to result in the reduction of funding levels and benefit security under plans than in the prevention of inappropriate reversions. In addition, opponents point out that reduced funding levels will tend to increase the risk of the Pension Benefit Guaranty Corporation and may eventually result in higher premium levels for the guarantees provided by that agency.

Opponents also argue that requiring plans to provide benefits it had not promised prior to plan termination would result in unfair discrimination among employees. They point out that an employee who separates from service after a plan termination would be treated better than an employee who separated from service and received benefits shortly before the termination. They believe that this discrimination is not justified.

Moratorium on reversions

Some believe that the issues relating to the conditions under which employers should be entitled to recover excess assets are sufficiently complex that a moratorium should be imposed on certain reversions to give Congress an opportunity to study the issue. They point out that one recently announced plan termination could involve a reversion of close to $1 billion. Some have recommended a moratorium on reversions that exceed $1 million.

Those who oppose a moratorium on reversions argue that, under a defined benefit pension plan, employees are entitled to the benefits promised under the plan rather than the fund from which the benefits are provided. They believe that if assets remain in the fund after a plan's obligations for benefits are met, those assets should be restored to the employer.

In addition, they point out that an employer who maintains a defined benefit pension plan bears the risk that benefits will be more costly than estimated by the plan's actuary because the employer will be obligated to provide additional funding. They argue that it would be unfair to require employers to bear the cost of unfavorable experience if they are not also allowed to benefit from favorable experience. Others argue that the employer does benefit from favorable experience. Those experience gains reduce employer liability to fund promised benefits. They question why it is appropriate to provide an additional benefit—tax-free growth—on amounts that are not used to provide retirement benefits. They argue that an excise tax sufficient to recapture that growth should be imposed if reversions are permitted.

Those opposed to a moratorium also believe that employers would expect it to be extended by the Congress for an indefinite period. They argue that a moratorium would have a chilling effect on the willingness of employers to fund plans at a level above that which will avoid penalties under the minimum funding standard. They argue that a moratorium would injure employees because it would cause employers to decelerate the funding of existing plans, thus lessening benefit security. They also argue that it would discourage employers from adopting and maintaining new defined benefit pension plans.

Investments in employer securities

Those who favor the proposal to further restrict holdings of employer securities under defined benefit pension plans believe that the present limits unduly expose employees to losses. They argue that, if the employer suffers financial distress, the employees will lose both their jobs and their retirement benefits. Accordingly, some argue that it is inappropriate to permit any pension plan assets to be invested in employer securities.

On the other hand, some believe that further restrictions would deny retirees the opportunity to benefit from growth in the value of employer securities. They argue that existing fiduciary standards and prohibitions against self-dealing and conflict of interest under the ERISA and the Code are adequate to deal with inappropriate investments in employer securities.

Spin-off terminations

Some have criticized the present rules for allocating assets under defined benefit pension plans when assets and liabilities are transferred to other plans. They believe that, if a plan is split into two or more plans, assets should be allocated in proportion to liabilities so that each of the successor plans will have the same level of benefit security. They argue that proportionality would prevent the allocation of all surplus to a plan that will be terminated. In addition, such a rule would maintain the existing level of benefit security in plans to which assets and liabilities are allocated. Proponents of a proportionality rule point out that an employer would not be permitted to recapture the excess assets attributable to a plan that continues in existence. Some argue that it is also necessary to consider the treatment of amounts directly transferred between plans if these rules are revised.

On the other hand, it has been argued that the requirement of proportionality would require plans to retain unneeded excess assets in a plan. Opponents of the proportionality proposal also argue that it could encourage employers to terminate a plan completely rather than continue it. They point out that the employer could obtain the entire amount of excess assets if no part of the plan is continued. Those who support the proposal, however, argue that the proportionality test is designed to require a continuation of benefit security under an ongoing plan and that it is not intended to prevent an employer from obtaining a reversion if a plan is not continued.

Interest rate on certain employee contributions

Those who favor an increase in the interest rate required to be credited on employee contributions under a defined benefit pension plan believe that, if the rate is below the market rate, investment yield on employee contributions will inappropriately reduce employer costs. They argue that employers should not be allowed to benefit by taking reversions derived in part from earnings on mandatory employee contributions.

It has been argued, however, that a higher rate of interest would tend to increase the cost of providing benefits under defined benefit pension plans and that a higher rate would penalize plans employers whose plans have suffered investment losses.

D. Additional Issues Relating to Tax Deferral Under Qualified Plans

Present Law and Background

Under present law, gross income does not include benefits provided for an employee under a qualified plan until those benefits are distributed. The exclusion applies even though the employee has no substantial risk of forfeiture with respect to the benefits. The minimum tax on tax preferences is not applied to benefits earned under a qualified plan.

Under present law, the investment yield on the assets of a trust forming a part of a qualified plan (a qualified trust) is generally exempt from income tax. A tax is applied, however, to the unrelated business income of such a trust. Similar treatment is provided for annuity contracts held under a qualified plan and for amounts held under an individual retirement account or annuity (IRA).

Administration Proposal

An excise tax would be imposed on certain excess contributions to qualified plans (see Part V. B. Deductions for Contributions to Qualified Plans, above). An excise tax would also be imposed on certain excess employer contributions to a plan with a cash or deferred arrangement (See qualified cash or deferred arrangements, part II. B., above.) Finally, an excise tax would be imposed on the amount reverting to an employer on termination of a qualified plan.

Other Proposals

H.R. 2424 (Schumer-Russo)

An amount equal to the increase in nonforfeitable benefits under a qualified plan during a taxable year, attributable to amounts allowed as a deduction, would be subject to the alternative minimum tax for individuals.

Excise tax on employer contributions

Some have suggested that an excise tax could be imposed on employer contributions to a qualified plan.

Tax on investment income of qualified plans

The income and gains of a fund under a qualified plan could be fully or partly subjected to income tax. The tax could be at a special rate uniformly applicable to all funding media (trusts, insurance products, and custodial accounts). The tax rate could be lower than the rate generally applicable to other taxpayers or the full rate of tax could be applied to a portion of the income and gains.

Analysis

In general

Concerns have been expressed that the tax expenditure for qualified plans is the largest single item of tax expenditures. Some believe that, in the context of fundamental tax reform, it is appropriate to reconsider whether a tax expenditure of this magnitude is appropriate.

Those who favor a reduction in the tax expenditure for qualified plans have suggested (1) that the increase in an individual's employer-derived vested benefits under qualified plans could be treated as a tax-preference item subject to the individual minimum tax, (2) that an employer's deductible contributions to a qualified plan could be treated as an item of tax preference that is subject to the corporate minimum tax, (3) that an excise tax could be imposed on employer contributions to qualified plans, or (4) that all or a part of the investment income on the assets of a qualified plan could be subject to current taxation.

Minimum tax

The proposal to treat vested benefits under qualified plans as tax preferences and subject them to the minimum tax would reduce the benefit of tax deferral available under a qualified plan. Those who support the proposal argue that the tax deferral available under qualified plans is particularly advantageous to individuals whose income is subject to higher marginal tax rates. They point out that qualified plans often provide a significant part of the total tax benefits enjoyed by these individuals and argue that benefits under qualified plans should be subject to the same rules that apply to other tax preferences.

On the other hand, it has been suggested that the proposal would increase the cost of maintaining a qualified plan because it would require recordkeeping and computations not presently required. In particular, it is argued that the proposal would require the annual measurement of the increased value of vested benefits for which deductions have been allowed. This calculation would be particularly difficult in a defined benefit pension plan where unallocated assets are accumulated to provide benefits.

Opponents point out that, if the tax is imposed on the increase in vested benefits, then the tax could cause hardship for employees covered by plans using deferred vesting schedules. In that case, benefits earned in prior years vest in a single year (e.g., plans commonly provide for full vesting of benefits after completion of 10 years of service) and the employee would be subject to tax in one year on several years' benefit accruals.

Others point out that the tax could be imposed many years before the benefits are actually distributed to the taxpayer. Thus, a tax would be imposed before the employee received the income to pay it.

Those who support the imposition of a minimum tax on vested benefits argue that the tax could be based on the value of benefits that both accrue and vest during a single taxable year. Some have suggested that a minimum tax could be imposed on the increase in benefits earned under a qualified plan, whether or not the benefits are vested. They argue that this approach would avoid the bunching of income in a single year caused by full vesting of benefits earned in earlier years. Those who oppose this approach argue, however, that it would result in taxation of benefits that may not be provided if the employee separates from service before completing enough service to have fully vested benefit rights.

Excise tax on employer contributions

It is suggested that an excise tax on employer contributions to qualified plans would recoup some of the special tax benefits provided for qualified plans. It is argued that imposition of the tax would not result in significant administrative problems for taxpayers because existing records would be sufficient to determine the level of the tax.

Opponents of the tax point out that if it is imposed on the plan, total tax expenditures may not be reduced because employers who maintain defined benefit pension plans would be required to increase plan contributions to cover the tax as well as their minimum funding obligations.

Those opposed to the tax also argue that it could have the effect of encouraging slower funding under qualified defined benefit pension plans.

Tax on investment income of qualified plans

Some favor the imposition of a tax on the investment income of a qualified plan. They argue that the present treatment of qualified plans is too favorable because it permits both a deduction for employer contributions and deferral of tax on investment income. They believe that a current deduction for employers and deferred income for employees with respect to employer contributions are sufficient incentives to encourage the retirement savings.

Those who oppose a tax on the investment income of qualified plans point out that the employer deduction does not provide an incentive to establish plans because the employer would generally be allowed a deduction if the amount paid to the plan as a contribution were instead paid to employees as current compensation. They also point out that if the investment income of a plan is taxed at the same rate as other income, then a qualified plan would not effectively reduce the tax burden on employees. They believe that, under present law, the principal tax savings provided by qualified plans to employees is the deferral of tax on the compounded investment income from plan investments. They argue that if plan income is taxed currently, then this source of tax savings will be eliminated. They point out that the tax savings provided to employees from deferral of employer contributions under a plan is offset by the tax imposed when benefits are distributed by the plan. Those who favor a tax on the investment income of qualified plans suggest that a measure of the tax savings for employees could be preserved if the tax on investment income of a qualified plan is imposed at a lower rate than that applicable to other income.

E. Estate Tax Exclusion for Qualified Plan Benefits

Present Law and Background

Annuities

Prior to the enactment of the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), certain employer-provided retirement benefits payable under qualified plans, tax-sheltered annuities, individual retirement accounts, annuities, or bonds (IRAs), and certain military retirement plans were fully excludable from a decedent's gross estate. Effective for decedents dying after December 31, 1982, TEFRA placed a $100,000 aggregate limit on the available estate tax exclusion (sec. 2039). This estate tax exclusion for retirement benefits was allowed in addition to any other exclusion or deduction (*e.g.*, the marital deduction (sec. 2056)) allowed with respect to such benefits.

The Deficit Reduction Act of 1984 (DEFRA) repealed the remaining $100,000 estate tax exclusion.[46]

Prior to the changes made by DEFRA, life insurance proceeds payable from a qualified plan that were includible in a decedent's gross estate were eligible for the estate tax exclusion afforded to qualified plan benefits.

Insurance proceeds

The extent to which life insurance proceeds (including proceeds payable under a qualified plan) are includible in a decedent's gross estate is determined separately. Proceeds from life insurance policies on the life of a decedent are includible in the decedent's gross estate if payable, directly or indirectly, to the estate or the executor (sec. 2042(1)). Proceeds payable to any other beneficiary are includible in the decedent's gross estate if the decedent possessed at his death any of the incidents of ownership, exercisable either alone or in conjunction with any other person.

The term "incidents of ownership" has been broadly construed. It is not a term limited to ownership of the policy in the technical legal sense; but it generally refers to the right of the insured or his estate to the economic benefits of the policy.[47]

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[46] DEFRA generally is effective with respect to decedents dying after December 31, 1984. However, the provisions do not apply to a decedent whose benefit was in pay status on December 31, 1984, and who, prior to July 18, 1984, made an irrevocable election to designate the form of the retirement benefit distribution (including the form of any survivor benefits).The effective date of the TEFRA reduction of the estate tax exclusion to $100,000 is similarly amended to continue the pre-TEFRA unlimited exclusion with respect to a decedent whose benefit was in pay status on December 31, 1982, and who, prior to January 1, 1983, had made an irrevocable election to designate the form of such benefits (but not necessarily the beneficiary thereof).

[47] The term includes the power to change beneficiaries, to surrender or cancel the policy, to assign the policy, to revoke an assignment, to pledge the policy for a loan, or to obtain from the insurer a loan against the surrender value of the policy, etc. Incidents possessed by a decedent are sufficient to mandate inclusion whether possessed as a trustee or otherwise even where the decedent otherwise has no beneficial interest in the trust.

Possible Proposal

It has been suggested that all benefits payable from qualified plans, tax-sheltered annuities, individual retirement accounts, annuities or bonds (IRAs) and certain military retirement plans should be treated in the same manner for purposes of the Federal estate tax, regardless of the character of the payment. Thus, all distributions, whether payable as an annuity or life insurance proceeds would be fully includible in the participant's gross estate. Other estate tax exclusions (e.g., the marital deduction (sec. 2056)) would continue to be available for qualifying benefits.

Analysis

The estate tax treatment of life insurance proceeds payable under qualified retirement programs raises the question of whether particular assets should be accorded special treatment under the Code. One issue is whether such proceeds to be subject to the rules governing retirement distributions or the rules governing life insurance proceeds. Another issue is whether it is more appropriate to create distinctions based on the source of the payment or the character of the asset.

In 1982 and 1984, Congress concluded that it was inappropriate to provide special estate tax exclusions for assets merely because they were in retirement plans. Accordingly, TEFRA reduced and DEFRA generally repealed, the prior law exclusion for certain employer-provided retirement benefits. Repeal of the exclusion did *not* cause all retirement benefits to be includible in a participant's gross estate. After the 1984 Act, in the case of assets in a retirement fund, inclusion depends on the character of the payment. If payable as an annuity, benefits will be includible (sec. 2039); if payable as life insurance proceeds over which the participant had not retained any incidents of ownership, the payments will *not* be includible (sec. 2042).

Those arguing that all qualified retirement benefits should be subject to the same estate tax rules would conclude that distinctions based on the form or character of the payment are inappropriate. Those arguing that it is inappropriate to make the estate tax treatment of life insurance proceeds depend on the source of the payment come to the opposite conclusion. If it is appropriate to provide an exclusion for insurance proceeds payable to a beneficiary other than the decedent (provided the decedent retained no incident of ownership), they believe the exclusion should be available whether or not the proceeds are paid under a qualified plan.

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