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The Employee Benefit Provisions of the Tax Equity and Fiscal Responsibility Act

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READER'S ANNOTATIONS

Unless otherwise indicated, all section references are to the Internal Revenue Code ("Code"). "FICA" refers to the social security tax; "FUTA," to the federal unemployment tax; "IRA," to an individual retirement account; "ISO," to an incentive stock option; "Service," to the Internal Revenue Service; "SEP," to a simplified employee pension; "TEFRA," to the Tax Equity and Fiscal Responsibility Act of 1982; "TIN," to a taxpayer identification number; and "TRASOP," to a tax-credit employee stock ownership plan.

Quite a number of the provisions of TEFRA will, directly and indirectly, have an impact on the benefits that employees receive in addition to their salaries. The various changes will be covered in this outline, beginning on the following pages.

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A. **Income Tax Withholding** (Code §§3405, 6047, and 6740; TEFRA §334)

1. For payments made after December 31, 1982, withholding of income tax will be required on taxable distributions to participants and beneficiaries from deferred compensation plans, IRAs, and commercial annuities, unless the payees elect otherwise. This compulsory withholding system replaces the existing voluntary withholding provisions.

2. Payors such as trustees and insurance companies will be responsible for the withholding, except that in the case of payments from plans qualified under section 401, employee annuities under section 403, or nonqualified TRASOPs, the plan administrator will be responsible for the withholding unless he directs the payor to withhold and furnishes him with the proper information.

3. Withholding will be required on taxable distributions or payments from:

   a. Qualified or nonqualified pension, annuity, profit-sharing, stock bonus, or other deferred compensation plans;

b. IRAs; or

c. Annuity, endowment, or life insurance contracts from licensed insurance companies.

d. Distributions include:

i. Taxable loans from plans;

ii. Partial surrenders of annuity contracts;

iii. Conceivably, other constructive distributions;

iv. In-service distributions; and

v. Withdrawals from profit-sharing plans or upon plan termination.

4. Withholding is not required for wages subject to regular income tax withholding or the portion of a distribution that reasonably seems not to be includable in gross income.

   a. Thus, to the extent that a distribution reasonably appears to consist of employee contributions, withholding is not necessary.

5. The regular income tax withholding rules apply to periodic payments. The covered payments are treated as if they were wages paid by an employer to an employee "for the appropriate payroll period."

   a. Periodic payments are typically annuity and pension payments, but they probably include installment distributions that do not vary substantially from year to year.

   b. The Service will provide guidance for the determination of the appropriate payroll period.

   c. The payee may file a regular withholding W-4 certificate claiming the appropriate personal and other exemptions.

d. If a withholding exemption certificate is not in effect, the payee will be treated as married with three exemptions. Thus, for 1983, there will be no withholding on the first $5,400 of periodic payments.

e. A payor will be required to notify every annuity recipient of the withholding rules each year, even if the total amount of the annual payments to the annuitant will not exceed $5,400. According to the Senate Finance Committee Report, the purpose of the notice is:

i. To prevent possible under-withholding when a recipient has other income;

ii. To ensure that recipients are aware that periodic payments are taxable; and

iii. To advise recipients that penalties may be incurred if the payments of estimated tax are not adequate and sufficient tax is not withheld from any designated distribution.

6. "Qualified total distributions" and other nonperiodic distributions, regardless of amount, are generally subject to a flat 10 per cent withholding. There is no minimum amount that is not subject to withholding, as with periodic distributions.

a. A "qualified total distribution" is any distribution that:

i. Is a designated distribution, such as a taxable distribution;

ii. Is made from a qualified plan;

iii. Reasonably appears to be made within one taxable year of the recipient, assuming, if the payor is not certain, that the taxpayer uses the calendar year; and

iv. Consists of the balance to the credit of the employee under the plan.

v. In many cases, a qualified total distribution will

qualify also as a lump-sum distribution for rollover and 10-year special averaging purposes, but there is no requirement that this be the case. Hence, even though withholding on a qualified total distribution will be based on presumed eligibility for 10-year special averaging — and long-term capital gain treatment that is possibly applicable because of pre-1974 plan participation — in many instances the qualified total distribution will not be eligible for special tax treatment. For instance, when a terminating participant in a profit-sharing plan receives his entire account balance in the year of termination and also a final profit-sharing allocation in the next year, both distributions are qualified total distributions, yet only the first will normally qualify as a lump-sum distribution eligible for special tax treatment.

b. "Nonperiodic distributions" are defined as all distributions other than periodic ones.

i. In-service distributions and withdrawals would normally be considered nonperiodic distributions.

ii. When a post-termination distribution provision allows the payee to vary the amount of particular installments of what otherwise would be regular periodic distributions, the distributions may be considered nonperiodic for withholding purposes.

iii. Unfortunately, the distinction between periodic and nonperiodic distributions is not clear in many cases. The Treasury, which opposed the use of the 10 per cent flat withholding tax on nonperiodic distributions, recognized this fact, but Congress thought otherwise.

c. Withholding on qualified total distributions is to be determined by methods prescribed by regulations to take into account the 10-year forward averaging provisions and, if available, the capital gains provisions for lump-sum distributions.

i. In addition, for qualified total distributions on account

of death, the $5,000 exclusion for death payments under section 101(b) is applied, whether or not allowable under the provisions of section 101(b).

d. Accumulated deductible employee contributions are treated separately in determining whether there has been a qualified total distribution.

e. The amount of withholding is limited to the cash and fair market value of the property, other than employer securities received in the distribution.

   i. Withholding on employer securities is never required.

f. Unlike periodic distributions, withholding on nonperiodic distributions is not based on the wage-withholding tables.

7. Elections-out of withholding by payees with regard to periodic distributions continue until revoked; with regard to nonperiodic distributions, they are good only for a single distribution.

   a. However, regulations will apparently be issued that will permit elections-out on nonperiodic distributions to apply to subsequent nonperiodic distributions made by the payor to the payee under the same arrangement.

   b. The procedures for electing-out will be prescribed by regulations.

8. A payor must notify payees of their right to elect not to have the tax withheld or to revoke such an election.

   a. For nonperiodic distributions, notice is to be provided no later than at the time of the distribution, though earlier notice may be required by the regulations.

      i. In order to permit a recipient of a lump-sum distribution to elect-out of withholding so that the entire amount of the distribution will be available for rollover, the regulations probably will require that a recipient of a total

distribution be informed of his right not to have withholding apply before the distribution is made, perhaps no more than 90 days and not less than 30 days before the distribution.

b. For periodic distributions, an initial notice must be provided no earlier than six months before and no later than the time of the first periodic payment made after December 31, 1982, and subsequent notices must be given at least once each year.

i. This annual notice probably will have to be provided no earlier than July 1 and no later than October 1.

9. Reports and returns will have to be submitted by employers who are plan sponsors, plan administrators, and insurers issuing contracts under which payments may be made to the Service, the plan or contract participants and beneficiaries, and any other person who is entitled to receive them under the regulations.

a. The details, forms, and necessary information are left to the regulations, but the Finance Committee Report indicates that the regulations should require the reports to include sufficient information to identify:

i. The total amount of the distribution;

ii. The amount of accumulated deductible employee contributions;

iii. The amount of nondeductible employee contributions;

iv. The amount of capital gain;

v. The amount of ordinary income;

vi. The cost basis of any employer securities included in the distribution; and

vii. Possibly in the case of qualified total distributions, the five-year participation rule and whether there has been a separation from service.

b. Increased penalties will apply in case of noncompliance with the reporting provisions.

10. Any person under a duty to file a report is required to maintain a data base that is sufficient for current or future reporting. The failure to maintain an adequate data base without reasonable cause may lead to a penalty of $50 per person, but not exceeding $50,000 per year.

a. The penalty applies whether or not reports are due for the period during which the recordkeeping failure occurs.

b. A penalty will not be imposed for a failure to meet the recordkeeping rules when the failure:

i. Is due to a reasonable cause, rather than willful neglect;

ii. Is a prior violation with respect to which the penalty has been imposed and reasonable correction efforts have been made;

iii. Or occurred before 1983 and reasonable correction efforts have been made. A person will be treated as having made reasonable efforts to correct a pre-1983 recordkeeping failure if he uses whatever records may be reasonably accessible and makes whatever calculations are necessary to determine the required information, like deriving employer and employee contributions from payroll withholding records or making reasonable estimates when accessible records are insufficient to allow for an approximation of the required information. While employers maintaining any type of plan under which employee contributions were made may have difficulty in generating pre-1983 data, employers with class-year plans who have used a multiple contract approach may have particular difficulties. Because of the unsettled state of the law

regarding the use of multiple contracts as compared to the single contract approach, such employers are likely to receive some relief.

11. Unlike the withholding on dividends and interest, which does not start until July 1, 1983, the pension withholding provisions are generally applicable to payments after December 31, 1982.

    a. The statute provides that when good-faith efforts to withhold were made, penalties will not apply for pre-July 1, 1983, failures to withhold if the payor actually withholds from any post-June 1983 payments a sufficient amount to satisfy the pre-July 1983 requirements.

    b. In addition, the regulations may delay, on a case-by-case basis, the effective date until June 30, 1983, for payors unable to comply without suffering undue hardship. If a waiver is granted, the payor will not be required to make up the withholding obligation out of post-June 1983 payments.

       i. In a floor colloquy between Senators Packwood and Dole, Senator Dole indicated that the case-by-case waiver was meant to apply to insurance companies and banks which administer a large number of plans. Before the Service can grant a waiver, however, it must be satisfied that the payor has made a good-faith effort to retrieve necessary information from employers whose plans it administers.

12. Reporting requirements begin January 1, 1983. Recordkeeping requirements are not effective until January 1, 1985.

B. Reductions in Benefits and Contributions (Code §415; TEFRA §235)

1. Under prior law, "annual additions" of employer contributions, forfeitures, and certain employee contributions to a profit-sharing or other defined contribution plan were limited

to the lesser of 25 per cent of compensation or $45,475. Annual benefits payable from a defined benefit plan were limited to the lesser of a participant's high three-year average compensation or $136,425. If defined benefit payments began before age 55, the dollar limitation was actuarially reduced to the equivalent of the annual dollar limit at age 55. The dollar limits of $45,475 and $136,425 for 1982 were automatically adjusted for cost-of-living increases as measured by the Consumer Price Index. If an employee participated in a defined contribution plan and a defined benefit plan maintained by the same employer, the fraction of the separate limits used by each plan was computed and the sum of the fractions was subject to an overall limit of 1.4. See §415.

2. TEFRA has established new dollar limits of $30,000 for defined contribution plans and $90,000 for defined benefit plans. The combined limitation was reduced from 1.4 to 1.25 for the dollar limitation only.

   a. For "top-heavy" plans, the combined limitation was reduced to 1.0 in certain situations.

   b. While the dollar limits were lowered, the limits of 25 per cent of compensation for defined contribution plans and 100 per cent of the high three-year compensation for defined benefit plans were not changed.

   c. Cost-of-living adjustments to the new dollar limitations were suspended for plan years beginning after December 31, 1982, and the dollar limits will not be adjusted again until 1986, based on post-1984 cost-of-living increases.

      i. When the cost-of-living adjustments begin again, the adjustments will be made on the basis of Social Security benefit increases, which, by 1986, are likely to be indexed on some basis other than the consumer price index exclusively.

3. New rules also apply to benefits commencing before and after

the normal retirement date and for all alternative benefit forms other than a single life annuity.

a. For early retirement benefits, an adjustment in the section 415 limits is now required if the benefits commence before age 62, rather than 55. The dollar limit need not be adjusted below $75,000 for participants age 55 or above, however, and the limit for ages below 55 is not less than the actuarial equivalent of a $75,000 annual benefit commencing at age 55.

b. These actuarial adjustments and adjustments to determine alternative benefit forms such as lump sums and 10-year-certain annuities are to be made using an interest rate of not less than the greater of five per cent or the rate specified in the plan.

i. Thus, if the plan's assumed interest rate for funding purposes is 8½ per cent, that rate, and not the lower five per cent rate, would have to be used to calculate the early retirement or actuarially equivalent benefits.

4. If a participant works beyond normal retirement date, the section 415 dollar limit in effect at the normal retirement date may be actuarially increased for the late commencement of the benefits. The interest rate assumption for adjusting this type of benefit is the lesser of five per cent or the rate specified in the plan.

   a. Under prior law, the Service took the position that a person retiring after the normal retirement date could not receive an annual benefit in excess of the section 415 dollar limit in effect at the time of retirement, even if the benefit was less than the actuarial equivalent of the section 415 dollar limit in effect at the time the participant reached the normal retirement date.

5. A special rule has been added to permit an employer to elect to continue making contributions to a profit-sharing plan or other defined contribution plan on behalf of an employee who is permanently and totally disabled.

a. Since the section 415 limits are based on an employee's "compensation," plans formerly were prohibited from making contributions on behalf of employees who had separated from service unless they were receiving disability benefits from the employer. The employer-provided benefits often were reduced quite sharply by integrating the plans with Social Security benefits.

b. The new provision applies to any permanently and totally disabled participant who is not an officer, owner, or highly compensated and whom the employer elects to have covered by the rule.

c. The employer's contributions must be fully vested when made.

d. The "compensation" taken into account for section 415 purposes is the participant's predisability pay.

6. For plans that were in existence on July 1, 1982, the reduction in the maximum contribution and benefit limits takes effect for plan years beginning after December 31, 1982. For plans that are adopted after July 1, 1982, the new rules take effect immediately. A delayed effective date applies to collectively-bargained plans, which must comply with the new rules on the earlier of the date the collective-bargaining agreement expires or January 1, 1986.

   a. Existing plans with a calendar year may be able to change to a fiscal year and thereby extend the period during which the old limits apply. Profit-sharing and stock bonus plans may change their plan years without Service approval, while pension plans need approval for such a change. Rev. Proc. 77-44, 1977-2 C.B. 578; Form 5308. If a plan year is changed, the limitation year should also be changed to conform with the plan year in order to obtain maximum advantage of the old limitations.

      i. These types of changes are quite complex and should be done only after careful consideration of all the relevant factors.

7. *Transition rules*

a. Benefits accrued by pre-January 1, 1983, plan participants in plans that were in existence on July 1, 1982, will not have to be reduced if they are in excess of the new limits. The grandfathered benefit is the accrued benefit as of the close of the last year beginning before January 1, 1983, if no changes in the terms of the plan and no cost-of-living adjustments were made after July 1, 1982.

i. A participant with a grandfathered accrued benefit in excess of the new limits will not be disadvantaged under the combined 1.25 rule, since the denominator of the defined benefit fraction in this case is considered to be the amount of the grandfathered benefit.

b. The computation of the defined contribution plan fraction that is part of the computation of the overall limit on contributions and benefits for participants in a defined contribution and a defined benefit plan has been complicated significantly. While the computation of the numerator of the fraction has not changed, the computation of the denominator has. For each year of service with an employer, the denominator is the lesser of 1.25 times the dollar limit in effect for that year or 1.4 times 25 per cent of the participant's compensation in that year.

i. Because this computation requires a year-by-year analysis, a special elective transition rule is also included for computing the defined contribution plan fraction for purposes of the combined plan limitation. The denominator of the fraction for pre-1983 years, calculated under pre-TEFRA law, may be multiplied by 1.25 or a greater number, depending on the participant's compensation during 1981.

ii. In addition to its simplicity, the transition rule has the effect of increasing the 1.25 factor to 1.4 for employees whose 1981 compensation was less than $148,214, and of gradually reducing the 1.4 factor to 1.25 for those earning between $148,214 and $166,000.

iii. Apparently, this transition rule must be elected for all participants if it is to be used at all. Thus, it may not be wise for an employer to use this transition rule if the information to compute the actual denominator of the defined contribution fraction is available. In that case, the computations should be made and then compared with the transition rule to determine which gives the best overall results.

c. Another transition rule applies if the sum of a participant's defined benefit and defined contribution plan fractions exceeds the new combined limit of 1.25. Although the Conference Committee Report intimates that a participant's future benefits would be frozen in that instance until the 1.25 rule is no longer exceeded, floor statements by Senator Dole and Congressman Rostenkowski indicate that the statement in the Conference Committee Report is incorrect. Instead, as the statute itself discloses, the intent is to provide a fresh start to insure that contributions or benefits under the higher limits of prior law do not have the effect of eliminating future benefit accruals altogether. The statute does not set forth specifics, but merely provides that the adjustment will be accomplished by reducing the numerator of the defined contribution plan fraction in accordance with regulations published by the Service.

8. TEFRA amends section 404 by providing that anticipated cost-of-living adjustments to the overall section 415 benefit limits may not be taken into account under the deduction rules.

a. This "clarification," as it was called in the Conference Committee Report, legitimizes the prior position of the Service that many believed to be of questionable validity.

b. According to the Conference Committee Report, deductions may still be based on salary projections as long as the benefit based on the assumed salary does not exceed the dollar limit applicable for the year.

9. *Planning considerations*

a. All qualified plans will have to be amended to incorporate the new section 415 limits. While a plan will not be disqualified before January 1, 1984, merely because it provides for benefits in excess of the new limits, plan amendments should not be delayed this long.

b. If the amendments are delayed and contributions are made during 1983 on the basis of the prior section 415 limits, the deduction will be lost for the excess contributions. Thus, benefit computations under the new limits should be developed by actuaries for 1983 funding purposes in order not to have excessive funding.

c. Companies that make the defined contribution plan the primary plan and that reduce the defined benefit plan benefit under the combined plan rule may find that they will have to adopt "excess benefit plans" if they have not already done so.

i. Until now, excess benefit plans have generally covered a handful of top employees. Under the new limits, however, many more employees are likely to have their benefits and contributions reduced, particularly under a cash or deferred plan pursuant to section 401(k), in which every dollar of a "salary reduction" contribution is considered an employer contribution, not an employee contribution, and counts toward the limits. Cash or deferred plans may not be as attractive under the new rules to highly paid employees who have already accrued a pension benefit of close to $90,000.

ii. As an example of the significant impact of the changes on highly paid participants, consider the case of a $300,000 a year officer with a projected benefit in excess of $90,000 who participates in a section 401(k) cash or deferred plan that allows salary deferrals of 10 per cent in addition to employer contributions of six per cent. If his defined contribution plan fraction is $100,000/$400,000, or 25 per

cent, at the end of 1982, and $30,000 is allocated to his account for 1983, his defined contribution fraction for 1983 is $130,000 [$100,000 + $30,000]/$537,500 [$400,000 + $30,000 x 1.25], or .242. The maximum pension he can accrue is $85,290 [$90,000 x 1.25 x .758 (1.0-.242)]. (The changes in the defined contribution plan fraction and the defined benefit plan fraction computations are reflected in these calculations.) This individual, therefore, will suffer a reduction in both his qualified pension plan benefit and his qualified defined contribution plan benefit.

iii. His situation could, perhaps, be worse if, for instance, his accrued benefit is $90,000 or more at the end of 1982. Can the defined benefit plan reduce his accrued benefit or must that accrued benefit remain payable from the qualified plan, in which case his contribution to the defined contribution plan would be reduced to 25 per cent of $30,000 or $7,500? The answer is not clear.

d. Employers that presently make the defined benefit plan the primary plan for limitation purposes, cutting back on contributions to the defined contribution plan, may want to change the order of priority. Of course, changing the order of the plans may not do much for employees whose benefits are already in excess of the new limits.

e. Because the changes were designed to increase revenues, it is likely that the Service will intensify its audits of plans to make sure that the limits are not being exceeded, particularly the defined benefit plan limits.

C. **Keogh Plans** (Code §§401, 404, 1379, and 4972; TEFRA §§237, 238, and 239)

1. Effective for years beginning after 1983, TEFRA eliminates most, but not all, of the distinctions in tax law between corporate qualified deferred compensation plans and those of self-employed individuals.

a. Special limits on contributions to, and benefits accruable

under, H.R. 10 ("Keogh") plans for self-employed individuals, like the limit on contributions of 15 per cent of earned income, will no longer exist.

b. The same definition of earned income will apply to the self-employed individual and the common law employee. In both cases, earned income will be computed after taking into account amounts contributed to a qualified plan to the extent a deduction is allowed for the contributions. A self-employed individual will be entitled to have contributed for his benefit to a qualified plan the same proportion of compensation as a common law employee.

i. For example, a self-employed individual such as a corporate director earning $100,000 in directors' fees in 1984 could contribute $20,000 to a money-purchase pension plan, since that is equal to 25 per cent of his earned income of $80,000 ($100,000 - $20,000), the maximum under section 415.

c. Special limits on nondeductible contributions by owner-employees to H.R. 10 plans and an excise tax on excess contributions made on behalf of owner-employees have been eliminated.

d. No longer must a trustee for an H.R. 10 plan be a bank or other approved financial institution. Individuals will be able to trustee their own plans.

i. The bank-trustee rule is still applicable to IRAs, however.

e. The $5,000 exclusion denied by present law to death benefits paid to self-employed individuals under section 101(b) will be available.

f. An H.R. 10 plan benefiting owner-employees will not have to include in the plan all employees who have completed at least three years of service with the employer.

i. However, the special rules for H.R. 10 plans under which all employees of all unincorporated trades or businesses controlled by an owner-employee are treated as if employed by a single trade or business for the purpose of the qualification rules of section 401(a) have been retained.

g. No longer must H.R. 10 plans covering owner-employees grant 100 per cent full and immediate vesting for all benefits and, if profit-sharing plans, provide a definite formula for determining contributions.

h. The consent of an owner-employee to participation in a qualified plan will not be necessary.

i. The Conference Committee Report points out, however, that TEFRA does not require that any provision eliminated by TEFRA must be deleted from the plan. For instance, an employer may prefer that an H.R. 10 plan continue to provide that an owner-employee must consent to participate, thereby permitting him to elect out of participation.

ii. Contributions on behalf of an owner-employee will be permitted within five years following an early withdrawal by the owner-employee.

2. TEFRA did not eliminate the rule that a self-employed individual may not deduct contributions to an H.R. 10 plan to purchase incidental life, health, or accident insurance. Also, a self-employed individual continues to be denied a basis in the amounts applied under an H.R. 10 plan to purchase life insurance protection for him.

D. Top-Heavy Plans (Code §416; TEFRA §240)

1. *Overview*

a. Top-heavy plans are a new category of plans primarily benefiting "key employees" that are subject to special

qualification requirements in addition to the regular rules. In general, the additional requirements:

i. Limit the amount of a participant's compensation that may be taken into account;

ii. Provide more rapid vesting of benefits and minimum nonintegrated contributions or benefits for plan participants who are not key employees;

iii. Reduce the aggregate limit on contributions and benefits for certain key employees; and

iv. Restrict distributions to key employees.

b. These new rules may be applicable in many different situations. They will clearly affect sole proprietors and any small business or professional organization whose owners and other key employees dominate participation in a benefit plan. They may also interest a large employer who is contemplating an acquisition of a small employer, since the large employer will want to know whether the small employer complied with the top-heavy rules, if applicable, for all years prior to the acquisition.

2. *Top-heaviness*

a. A defined benefit plan is a top-heavy plan for a plan year if, as of the determination date, the present value for the plan year of the accumulated accrued benefits for participants who are key employees exceeds 60 per cent of the present value of the accumulated accrued benefits for all employees under the plan.

i. Since a method of computing present value is not prescribed, presumably reasonable actuarial assumptions can be utilized.

b. A defined contribution plan is a top-heavy plan for a plan year if, as of the determination date, the sum of the ac-

count balances of participants who are key employees for the plan year exceeds 60 per cent of the sum of the account balances of all employees under the plan.

c. A defined benefit or defined contribution plan can be top-heavy even if key employees do not participate in the plan if the plan is a part of a top-heavy group.

d. The determination date for any plan year generally is the last day of the preceding plan year. Consequently, if an ongoing plan becomes a top-heavy plan in 1986 for the first time, the plan will not have to comply with the top-heavy plan rules until 1987.

i. In the case of the first plan year of a plan, however, the determination date is the last day of that year.

ii. Further, to the extent provided in regulations, the determination date may be set on the basis of a year other than a plan year.

e. Benefits derived from both employer and employee contributions generally are taken into account for the purpose of determining the present value of the accumulated accrued benefits under a defined benefit plan and the sum of the account balances under a defined contribution plan. However, accumulated deductible employee contributions under a plan are to be disregarded.

f. To ensure relative stability and to preclude distortions under the top-heavy plan computation, the present value of the accrued benefit of a participant, whether or not he is a key employee, in a defined benefit plan or the account balance of a participant in a defined contribution plan also generally includes any amount distributed with respect to the participant under the plan within the five-year period ending on the determination date.

g. A rollover contribution or similar transfer made after December 31, 1983, generally is not taken into account in the transferee plan for the purpose of the top-heavy plan

computation. Thus, when an employee changing employers rolls over an account balance or benefit from his prior employer's plan, the amount in the account would not be considered in determining whether the new employer's plan is top-heavy.

i. According to the Conference Committee Report, this rule will not apply if the contribution or transfer is made incident to a merger or consolidation of two or more plans or the division of a single plan into two or more plans. Therefore, a top-heavy plan can be merged with a non-top-heavy plan and the resulting plan may or may not be top-heavy.

ii. In addition, the Conference Committee Report provides that this rule will not apply to rollover contributions or transfers between plans of the same employer, including plans of related employers that are treated as a single employer under section 414.

iii. Of course, in any case in which a rollover contribution or transfer must be taken into account in the transferee plan, the amount distributed by the transferor plan is not taken into account in the transferor plan.

h. If an employee ceases to be treated as a key employee, his accrued benefit under a defined benefit plan or his account balance under a defined contribution plan is disregarded during the top-heavy plan computation for any plan year following the last plan year for which the employee was treated as a key employee.

3. *Key employees*

a. Key employees generally include employees who are plan participants and who:

i. Are officers;

ii. Are among the 10 employees owning the largest interests in the employer;

iii. Own more than a five per cent interest in the employer; or

iv. Own more than a one per cent interest in the employer and receive from the employer more than $150,000 in annual compensation.

b. No more than 50 officers of any company will be considered key employees. If a company has less than 50 officers, only the greater of three officers or the number of officers that corresponds to 10 per cent of all officers will be considered key employees.

c. An employee is considered an officer or an owner of an interest in the employer if the employee was an officer or owner of an interest at any time during the plan year or the four preceding plan years.

d. In the case of an employer with more officers than are required to be counted as key employees, the officers with the highest compensation will be considered key employees.

e. According to the Conference Committee Report, whether an employee is an officer is determined under existing law. Generally, the term "officer" means an administrative executive who is in regular and continued service.

i. This definition excludes employees engaged for a special or single transaction or with only nominal administrative duties.

ii. Thus, all the employees of a bank with the title of vice president or assistant vice president will not automatically be considered officers.

f. An employee owns more than a five per cent interest in a corporate employer if he owns more than five per cent of the employer's outstanding stock or stock possessing five per cent of the total combined voting power. He is also treated as owning stock owned by certain members of his family or, in certain cases, by partnerships, estates, trusts, or corporations in which he has an interest.

i. The same rules apply to determine whether an individual owner is a one per cent owner.

g. In the case of a noncorporate employer, ownership will be determined in accordance with Treasury regulations that follow the constructive ownership principles of section 318.

h. To determine whether a self-employed individual who is a one per cent owner is a key employee, the annual compensation in excess of $150,000 must come from the trade or business with respect to which the plan is maintained.

i. The top-heavy rules do not apply to any employee included in a unit of employees covered by a collective bargaining agreement if retirement benefits were the subject of good-faith bargaining. In other words, if an employee who would otherwise be a key employee belongs to a collective bargaining unit, he will not be considered a key employee.

4. *Qualification rules*

a. A top-heavy plan is qualified only if the regular qualification rules and some additional requirements are met. Except as the Service may provide by regulations, a plan, whether or not top-heavy in fact, will constitute a qualified plan only if it includes provisions that:

i. Will automatically take effect if the plan becomes top-heavy; and

ii. Meet the additional qualification requirements for top-heavy plans.

b. For any plan year for which a plan is top-heavy, only the first $200,000 of an employee's compensation may be taken into account in determining contributions or benefits under the plan. Beginning in 1986, this $200,000 limit will be adjusted in line with the overall limits on contributions and benefits under section 415.

i. For a self-employed individual, compensation means earned income, which is determined after any contribution to a qualified plan.

c. For any plan year for which a plan is top-heavy, an employee's right to the accrued benefit derived from employer contributions must become nonforfeitable under a vesting schedule that satisfies one of two alternatives — three-year full vesting or six-year graded vesting. These alternatives apply to all accrued benefits, whether or not the accrued benefits are required by the top-heavy plan rules.

i. A plan will satisfy the three-year full vesting alternative if an employee who has at least three years of service with the employer or employers maintaining the plan has a nonforfeitable right to 100 per cent of his accrued benefit derived from employer contributions. As under present law, a plan that provides three-year 100 per cent vesting will satisfy the participation requirements if employees with three years of service who are at least 25 years old are eligible to participate.

ii. Six-year graded vesting is the second alternative. An employee must have a nonforfeitable right to at least 20 per cent of the accrued benefits derived from employer contributions at the end of two years of service with the employer, 40 per cent at the end of three years of service, 60 per cent at the end of four years of service, 80 per cent at the end of five years of service, and 100 per cent at the end of six years of service.

iii. For the purpose of determining service under these vesting schedules, the present rules relating to years of service, breaks in service, and certain permitted forfeitures apply. Accordingly, all years of service with the employer generally are to be taken into account, including years of service completed prior to the enactment of TEFRA and service during periods when the plan was not a top-heavy plan.

d. For a plan year for which a defined benefit plan is top-heavy, each plan participant who is not a key employee for the year generally must accrue a benefit that, when expressed as an "annual retirement benefit," is not less than two per cent of the employee's average annual compensation from the employer during the employee's "testing period," multiplied by the employee's years of service with the employer. However, the minimum benefit need not exceed 20 per cent of the employee's average annual compensation.

i. All years of an employee's service otherwise required to be taken into account under the plan generally must be taken into account to determine the minimum benefit, except a year of service ending before the date of enactment or within a plan year for which the plan is not top-heavy.

ii. The minimum benefit is a nonintegrated benefit. Only benefits derived from employer contributions to the plan are taken into account and an employee's social security benefits are disregarded. The required minimum benefit may not be eliminated or reduced on account of the employee's social security benefits attributable to contributions by the employer.

iii. The term "annual retirement benefit" is defined as a benefit payable annually in the form of a life annuity beginning at the plan's normal retirement age with no ancillary benefits.

iv. An employee's "testing period" is the period of the employee's consecutive years of service, not exceeding five years, during which the employee had the greatest aggregate compensation from the employer. A year of service — and the compensation paid to the employee during that year — need not be included in the employee's testing period if it ends before the date of enactment or begins within or after the last plan year for which the plan is a top-heavy plan.

e. For a plan year for which a defined contribution plan is

top-heavy, the employer generally must contribute on behalf of each plan participant who is not a key employee for the year an amount not less than three per cent of the participant's compensation. Employer contributions attributable to a salary reduction, a section 401(k) cash or deferred arrangement, or similar arrangement, are not considered employer contributions. If the employer's contribution for each participant who is a key employee for the plan year is less than three per cent, the required minimum contribution rate for each non-key employee generally need not be more than the highest contribution rate for any key employee.

i. For example, if, under a profit-sharing plan, the employer contributed nothing for any key employee because of a lack of profits, then no contribution is required for any non-key employee.

ii. Reallocated forfeitures are considered as employer contributions.

f. Specific rules are provided to prevent inappropriate omissions or duplication of minimum benefits or contributions. The rules preclude an employee who is covered under more than one plan from receiving lower benefits or contributions than he would receive were he covered under one plan. Similarly, larger total benefits will not be required generally merely because an employee is covered under more than one plan.

i. Thus, if a non-key employee participates in both a defined benefit and a defined contribution plan, the employer is not required by new section 416 to provide the non-key employee with both the minimum benefit and the minimum contribution. For example, if an employee participates in a top-heavy money purchase pension plan that provides an annual nonintegrated contribution rate of five per cent of compensation — which meets the minimum contribution test — and a defined benefit plan that provides an annual benefit that is less than two per cent of

pay, the employer would not be required to provide a minimum benefit of two per cent of compensation for the non-key employee participating in the defined benefit plan.

5. *Extra top-heavy plans*

   a. If a key employee participates in both a defined contribution and a defined benefit plan that are top-heavy, additional rules with respect to the section 415 limits on contributions and benefits are applicable to what may be called "extra top-heavy plans."

   b. Unless certain requirements are met, for any year for which the plans are included in the top-heavy group, the aggregate limit for the key employee is the lesser of 1.0 applied only to the dollar limits or 1.4 as determined under present law. The aggregate limit is increased to the lesser of 1.25 applied only to the dollar limits or 1.4 as under present law if the plans of the employer in which the key employee participates meet the requirements of the concentration test and provide an extra minimum benefit, in the case of the defined benefit plan, or an extra minimum contribution, in the case of the defined contribution plan, for non-key employees participating in the plans. The extra contribution or benefit is in addition to the minimum contribution or benefit required for all top-heavy plans.

   c. The concentration test is generally satisfied with respect to a key employee for a year if, as of the last determination date before the first day of that year, the sum of the present value of the accumulated accrued benefits for key employees under the defined benefit plan in which the key employee participates and the sum of the account balances of key employees under the defined contribution plan in which the key employee participates are not greater than 90 per cent of the amount for all participants under the plans. For the purpose of this computation, the rules for determining whether two or more plans constitute a top-heavy group apply.

d. The requirement for an extra minimum benefit for non-key employees is satisfied for a year if, for the plan year ending with or within that year, each non-key employee who is a participant in a defined benefit plan in which the key employees participate accrues an extra benefit which, when expressed as an annual retirement benefit, is not less than the lesser of one per cent of the employee's average annual compensation, multiplied by the employee's years of service with the employer, or 10 per cent of such average annual compensation. The requirement for an extra minimum contribution is satisfied with respect to a non-key employee for a year if, for the plan year ending with or within that year, the employer contributes on behalf of each non-key employee who is a participant in a defined contribution plan in which the key employees participate an extra amount that equals at least one per cent of the non-key employee's compensation for the year.

e. If a top-heavy plan fails to satisfy either the concentration test or the extra minimum benefit or contribution tests, the overall dollar limit for a key employee is 1.0 rather than 1.25.

i. However, a special transition rule appears to be effective — although this is not entirely clear — which directs the Service to issue regulations specifying that the numerator of the defined contribution plan fraction is to be reduced until the overall limit is satisfied, so that any key employee affected will be able to continue to have contributions made to his account or additional benefits accrued under a defined benefit plan.

ii. The uncertainty about the applicability of this special transition rule is caused by differences among TEFRA's changes in Code section 415, floor statements by Senator Dole and Congressman Rostenkowski, and certain provisions of new section 416. Section 416(h)(3), for instance, seems to provide that if the extra top-heavy rules apply, a key employee will not be permitted further benefit accruals under a defined benefit plan and additional em-

ployer or employee contributions to a defined contribution plan until either the aggregate of the key employee's accrued benefits and annual additions — as adjusted for any pre-1983 excess over the 1.0 dollar limit — is less than 1.0 applied to the dollar limits, or the concentration and minimum contribution and benefit tests are met. Technical corrections appear to be necessary to resolve the apparent conflicts.

6. *Top-heavy groups*

a. Special rules are provided under which two or more plans of a single employer are aggregated to determine whether the plans are top-heavy as a group. The group must include any plan that covers a key employee and any plan upon which a plan covering a key employee depends for qualification under the Code's coverage or the antidiscrimination rules.

b. In addition, in testing for top-heaviness, an employer may elect to expand the aggregated group to take into account any other plan maintained by him, if the expanded group continues to satisfy the coverage and antidiscrimination rules.

i. For example, a plan covering exclusively non-key employees can electively be considered to be part of the top-heavy group in testing for top-heaviness.

c. An aggregated group is a top-heavy group if, as of the determination date, the sum of the present values of the accumulated accrued benefits for key employees under any defined benefit plans included in the group and the sum of the account balances of key employees under any defined contribution plans included in the group exceed 60 per cent of the amounts for all participants in all the plans included in the group.

d. If an aggregated group is a top-heavy group, each plan required to be included in the group is a top-heavy plan. A

plan included in the group at the election of the employer is not subject to the top-heavy plan rules on account of that election.

e. For example, a small service business with 50 employees has a money purchase pension plan covering all employees and providing a benefit of three per cent of pay per year of service. In addition, the employer has an integrated defined benefit plan providing benefits of two per cent of final pay in excess of the social security wage base. The money purchase pension plan's account balances for key employees total 50 per cent of all account balances, so that the plan, by itself, is not top-heavy. However, the accrued benefits under the defined benefit plan belong 100 per cent to key employees. Aggregation of the two plans will produce a top-heavy group, because the account balances and benefits for key employees together exceed 60 per cent of the total account balances and benefits.

7. *Distributions to key employees*

a. The rules previously applicable to H.R. 10 plans of owner-employees under section 72(m)(5) have been extended to distributions from top-heavy plans to key employees. If a distribution is made to a key employee before he attains age 59½, an additional tax is imposed equal to 10 per cent of the amount includable in income, unless the distribution is made on account of death or disability.

b. In addition, under section 401(a)(9), a top-heavy plan must provide that distributions to a key employee will commence no later than the taxable year in which the key employee attains age 70½, whether or not he separates from service in that year.

i. Presumably, distributions must be made in the same manner as under present Keogh rules, so that the total benefits are payable to the employee over his life expectancy or the joint life expectancy of the employee and his spouse. There is a misleading statement in the Conference

Committee Report suggesting that only 50 per cent of the benefits need be paid over that period.

E. Loans from Qualified Plans (Code §72; TEFRA §236)

1. Under prior law, participants could borrow from all qualified plans other than H.R. 10 plans. To comply with the prohibited transaction rules, the loans had to be available to all participants on a reasonably equivalent basis, be adequately secured, bear a reasonable interest rate, be available on a nondiscriminatory basis, and be made in accordance with specific plan provisions. There was no statutory rule regarding the length of the repayment schedule, but the Service approved 10-year repayment periods in a number of private letter rulings. A loan was treated as a taxable distribution only if there was a tacit understanding that collection was not intended or the transaction did not create a bona fide debtor-creditor relationship. Rev. Rul. 71-437, 1971-2 C.B. 185.

2. For loans from qualified plans made after August 13, 1982, TEFRA tightens the rules, without changing, however, the present prohibited transaction rules and fiduciary standards. A loan — or an assignment or pledge of a participant's interest — is treated as a taxable distribution unless certain conditions are met.

   a. A loan will be treated as a taxable distribution to the extent the loan, together with any other outstanding loans made after August 13, 1982, exceeds the lesser of $50,000 or one-half of the present value of the employee's vested accrued benefit, but not less than $10,000.

      i. The maximum nontaxable loan for a participant with a $200,000 vested benefit is $50,000, and the maximum loan for a participant with a $15,000 vested benefit is $10,000.

   b. Even a loan that meets the fiscal limits will be treated as a distribution unless the loan by its terms must be repaid within five years. A loan applied toward the acquisition, construction, reconstruction, or substantial rehabilitation

of the participant's principal residence or the principal residence of one of his family members must be repaid within a "reasonable time."

i. According to the Conference Committee Report, a "principal residence" includes a house, apartment, condominium, or mobile home not utilized on a transient basis that is used, or will be used within a reasonable time, as a principal residence.

ii. Whether a loan meets the five-year rule is determined on the date the loan is made.

iii. A loan that is treated as a taxable distribution because the repayment schedule is too long does not become a nontaxable loan merely because it is repaid within five years.

iv. If a loan that originally qualifies under the five-year rule is extended beyond the five-year period, the balance of the loan at the time of the extension is treated as distributed.

v. A scheduled change in the interest rate under a variable rate contract will not be treated as a loan revision or renegotiation.

vi. TEFRA does not require any particular repayment schedule within the five-year limit; therefore, it appears that "balloon" loans are permitted.

vii. TEFRA also leaves open the question whether the loan term can extend beyond the normal retirement date. Under prior law, the Service took the position that the normal retirement age was the outside limit on the term of a loan to avoid having the loan treated as a distribution. *See Employee Plans Examination Guidelines Handbook* §614.3(3).

3. The Conference Committee Report provides an exception to the new loan rules when a plan invests in residential real estate mortgages as part of an "investment program" and the

amount of the mortgage loan does not exceed the fair market value of the property purchased with the loan proceeds.

a. An investment program will exist when the trustees determine that a specific percentage or amount of plan assets will be invested in residential mortgages.

b. The exception does not apply to investments made under individually-directed investment programs.

c. Although the Conference Committee Report does not say so explicitly, the Senate Finance Committee Report and a floor statement by Senator Packwood indicate that the exception applies only if the mortgage loan is fully secured by the property purchased with the loan proceeds — and perhaps secondarily secured by the participant's account balance.

d. While the Conference Committee Report also states that the exception does not cover investment loans that benefit an officer, director, or owner, a colloquy between Senators Packwood and Dole on the Senate floor attempts to nullify the effect of this sentence.

e. The investment-loan exception is fairly narrow in scope. Like any other participant loan, an investment-type loan is subject to the prohibited transaction rules as an extension of credit between the plan and a party in interest. If the exemption applies only when the program is limited to a percentage of plan assets, the statutory loan exemption, which requires that loans be available to all participants and beneficiaries on a reasonably equivalent basis, may not be satisfied simultaneously. Therefore, as a practical matter, the investment-loan exception may be available only for loans that are exempted from the prohibited transaction rules under the Department of Labor's recent exemption covering certain mortgage loans, or participation interests in such loans, that are made or purchased at the discretion of an independent "qualified real estate manager." *See Class Exemption for Investments in Resi-*

dential Mortgage Financing Arrangements, Prohibited Transaction Exemption 82-87 (May 18, 1982).

4. According to the Senate Finance Committee Report, a loan will not be treated as a distribution for plan qualification purposes just because it is taxable under the new rules. Nonetheless, cash and deferred plans and pension plans are not free to structure loans without regard to plan qualification.

   a. For example, if a participant in a pension plan or a cash or deferred arrangement fails to repay a five-year loan that is secured by his account balance, a levy on the account before the participant terminates employment — or, in a cash or deferred plan, before age 59½ or the occurrence of "hardship" — will affect plan qualification. *See* Rev. Rul. 71-437, 1971-2 C.B. 185.

   b. Similarly, if a five-year loan is extended beyond the original five-year term, the extension of the loan may indicate that collection was never intended and that a "distribution" has been made for both income tax and qualification purposes.

5. Although the new law applies generally to loans made after August 13, 1982, a loan that is outstanding on August 13, 1982, may be renewed or extended without being considered to be a new loan as long as the loan must be repaid on or before August 13, 1983, and it is in fact repaid before that date.

6. The final loan-provision language represents a considerable improvement over the Senate-passed version that would have limited most loans to $10,000. The increase in the maximum loan amount to $50,000 and the floor of $10,000 make the possibility of a loan a greater inducement to lower-paid employees to participate in a section 401(k) cash or deferred arrangement and to increase salary deferrals under the plan. An additional positive factor is that the interest on a loan is tax deductible, except that interest on other than a housing loan will be nondeductible for the alternative minimum tax.

7. Plans that are already offering participant loans may have to be revised if only nontaxable loans are to be available. But there is no apparent reason why taxable loans cannot be offered by a plan that can make in-service distributions, even if the participants are unlikely to want those loans. If taxable loans are offered, the employer will be required to withhold tax on the loan under the new pension withholding rules.

   a. The withholding and recordkeeping requirements potentially apply to all plan loans, since a nontaxable loan will be treated as a taxable distribution if a participant fails to repay the loan at the end of the five-year period.

F. Reporting Provisions (Code §§6652, 6678; TEFRA §315)

1. Penalties for certain failures to report have been increased from $10 to $50 per failure and from $25,000 to $50,000 per year. In addition, for an intentional disregard of the filing requirements, there is a penalty of 10 per cent of the aggregate amount of the items required to be reported, without a $50,000 per year limitation.

   a. The Senate Finance Committee Report notes that although the penalty for failure to file information returns has been little used in the past, the Service should use the increased penalties more often in order to protect the information reporting and withholding systems.

2. Covered reports in the employee tax and benefit areas include those under sections 6041(a) relating to information at the source, 6041A relating to returns regarding direct sellers, 6050A relating to the reporting requirements of certain fishing boat operators, 6052 relating to wages in the form of group term life insurance, and 6053 relating to tips.

3. Penalties for the failure to make certain reports in connection with qualified plans were increased to $50 per day from $10, up to a yearly maximum of $15,000, rather than $5,000. Covered reports include the annual report on Form 5500 and those required under section 6047, involving Keogh, annuity, and bond purchase plans and IRAs.

4. Penalties for the failure to furnish certain statements to persons about whom reports have been made have been increased from $10 to $50 per failure, to a yearly maximum of $15,000, up from $5,000. In the employee tax and benefit area, covered statements include those required by sections 6039 relating to statutory stock options, 6041 relating to withholding at the source, 6050A relating to certain fishing boat operators, 6051 relating to income tax withholding, 6052 relating to wages paid as group term life insurance, and 6053 relating to tips.

5. These provisions are effective for returns or statements required to be filed after December 31, 1982, without regard to extensions.

G. **Incentive Stock Options** (Code §57(b)(10); TEFRA §201)

1. In the past, the exercise of qualified stock options resulted in an item of tax preference for the "add on" minimum tax on the spread between the option price and the value of the stock on the date of exercise, whereas the deduction for long-term capital gain was an item of tax preference for the alternative minimum tax. When ISOs were authorized in 1981, Congress did not provide for preference tax treatment on the spread, and although the capital gain deduction remained a preference item for the alternative minimum tax, the amount rarely had an impact.

2. Under TEFRA, for years after 1982, the exercise of an ISO will result in an item of tax preference for the new alternative minimum tax, equal to the spread at the date of exercise. This spread is also subject to capital gain on the sale of the stock, with 60 per cent of the capital gain being another item of tax preference in the year of sale, resulting in a double preference.

   a. These preference items are aggregated with 10 other types of preference income in calculating the new 20 per cent alternative minimum tax.

   b. Since capital gain and the ISO spread are now lumped to-

gether, rather than determined under separate minimum tax calculations, holders of ISOs, particularly those with other preference income, will be more likely to incur a minimum tax than previously. Although optionees may have elected ISOs rather than nonstatutory options in reliance on the absence of a minimum tax, the change made by TEFRA will apply to options exercised after 1982 regardless of their date of issue.

3. An executive fully subject to the alternative minimum tax would pay a 20 per cent tax on the spread at exercise and another 20 per cent tax on the spread upon the sale a year or more later. If the total alternative minimum tax in the year of sale of the option stock is greater than the regular tax, the minimum tax will be payable instead of — and not in addition to — the regular tax.

4. Perhaps any elections to exchange nonqualified options for ISOs that have not been completed because the election statement has not been filed by the employer should be reviewed.

5. The Conference Committee Report states that the spread will not be treated as a preference item if the ISO stock is the subject of a disqualifying disposition. Apparently, this will be the case whether or not the disposition occurs before the due date of the return for the year of exercise.

H. Medicare Payments (TEFRA §116)

1. TEFRA amends the federal Age Discrimination in Employment Act to require, effective January 1, 1983, that employers offer the same health benefits to employees over age 65 as are offered to younger employees, with the employer plan the primary payor for these benefits.

   a. The Labor Department's permission to employers to "carve out" medicare coverage from employer-oriented benefits has thus been overruled.

2. The change applies to the coverage of employees and their

dependents. In other words, employees and their spouses who are ages 65 to 69 must be offered the same health benefits available to employees and spouses under 65.

3. The new provision does not prohibit an employer from offering the post-age-65 medical benefits under a cafeteria plan. According to the Conference Committee Report, "it is the intent of the conferees that an employee will have the option of rejecting the plan offered by the employer, thereby retaining medicare as primary coverage."

I. **The Timing of Distributions** (Code §401(a)(9); TEFRA §242)

1. Under present law, qualified corporate plans have not been subject to any mandatory statutory requirements concerning the commencement of distributions and the periods of payout, like those applicable to Keogh plans and IRAs. Rather, the corporate plans have been governed by an administrative rule which required generally that the method of payout should cause the retiree to receive, over his life expectancy at retirement, more than 50 per cent of the total present value of his benefits at retirement. Rev. Rul. 72-241, 1972-1 C.B. 108.

2. TEFRA specifies the latest permissible commencement date for distributions and prescribes a maximum payout period. Plans and IRAs must provide that:

   a. Distribution commences by the later of age 70½ or retirement;

   b. Distribution must be either in the form of a joint and survivor annuity with the employee's spouse or be made over a period that does not exceed the employee's — or the employee's and his spouse's — life expectancy;

   c. If unpaid amounts remain at the death of the employee — or, if distribution has commenced under a form of payment that continues to the employee's spouse, at the death of the spouse — distribution must be completed within five years, unless the benefits commenced under a payout

method that spreads payments over a period measured by the life expectancy of the employee and his spouse, in which case distribution may continue under that method.

3. These rules are effective for plan years beginning after 1983, but if a designation under the old rules is on file before the end of 1983, that designation will be honored even if it does not satisfy the new rules.

4. Although the incentive for a lengthy postponement of distributions is significantly reduced by the new limitation on the estate tax exclusion, some employees may wish to file a designation before 1984 to take advantage of the old rules for purposes of the $100,000 exclusion and the continued income tax advantages of deferral. Employers may also consider amending their qualified defined contribution plans prior to 1984 to offer the alternative of postponing the commencement of distributions until age 70½ in accordance with the new statutory rule.

J. The Integration of Defined Contribution Plans (Code §401(1); TEFRA §249)

1. Most employers integrate their qualified plans with Social Security. In larger companies, however, integration is usually carried out in a defined benefit pension plan rather than a defined contribution profit-sharing, savings, or money purchase plan. TEFRA has changed the defined contribution integration rules. These rules, developed administratively, allow an employer maintaining an integrated plan to contribute annually a differential of seven per cent of compensation on amounts over the wage base, currently set at $32,400.

2. Effective for plan years beginning after 1983, this seven per cent allowance will be replaced with a percentage equal to the employer's portion of the Old-Age and Survivor's Disability Insurance tax rate for the year in question, currently set by Congress at 5.4 per cent through 1984, 5.7 per cent through 1989, and 6.2 per cent thereafter.

a. Although defined benefit plan integration was not changed by TEFRA, it is probable that Congress will address this matter, together with broader Social Security issues, next year.

K. The Estate Tax Exclusion (Code §2039; TEFRA §245)

1. Among the most significant advantages of qualified plans has been the exclusion from the employee's gross estate of the amounts remaining to be paid at death and passing to designated beneficiaries. While the adoption of the unlimited marital deduction and the raising of the estate tax threshold in 1981 reduced the importance of this exclusion for the majority of employees, for those executives whose qualified benefits were expected to exceed the amounts needed for retirement income, the estate tax exclusion remained a valuable estate planning tool.

2. TEFRA dramatically changes this situation. For persons dying after December 31, 1982, the aggregate IRA and qualified plan exclusion is limited to $100,000.

3. The gift tax exclusion, which prevents the imposition of the gift tax when optional forms of benefits are elected, remains unchanged. The elimination of most of the benefits of the estate tax exclusion, however, may make the review and, probably, the revision of the estate plans of most top executives advisable.

L. Personal Service Corporations (Code §269A; TEFRA §250)

1. In recent years, professionals, athletes, performers, and others increasingly have incorporated in order to obtain better qualified plan benefits and for other reasons. To stem this tide, a new provision added to the Code states that if a corporation whose principal activity is the performance of personal services through employee-owners for or on behalf of another corporation, partnership, or entity, including related parties, is used for the principal purpose of evading or avoiding federal income tax by securing for any employee-

owner significant tax benefits that would not otherwise be available, then the Service may allocate all income, deductions, credits, and exclusions among the corporation and its employee-owners.

a. An employee-owner is defined as any employee who owns, after the application of the attribution rules in section 318, more than 10 per cent of the outstanding stock of the corporation.

b. The Conference Committee Report states that this provision is intended to overturn the result reached in cases like *Keller v. Commissioner*, 77 T.C. 1014 (1981), "where the corporation served no meaningful business purpose other than to secure tax benefits which would not otherwise be available."

c. The new section presumably will not reach a small incorporated firm or incorporated sole practitioner performing services for a wide clientele, but will prevent the use of partnerships consisting of incorporated individuals or groups of individuals.

2. The provision applies to taxable years beginning after December 31, 1982. Since the provisions of TEFRA granting parity to qualified plans of corporate and noncorporate entities do not take effect until 1984, however, certain incorporated individuals could lose the qualified plan benefits of incorporation in 1983.

   a. Apparently, however, some liberality will be applied during 1983. In a floor statement made when TEFRA was being considered, Senator Dole asserted that a personal service corporation will not be considered to be formed or availed of for the purpose of evading or avoiding federal income tax solely because, for 1983, the qualified plan rules will permit higher contributions and other advantages for corporate employees. The Service will not take a corporation's retirement plan into account during 1983.

M. Management Employees (Code §414(m); TEFRA §246)

1. Presently section 414(m) applies only to service organizations, treating them as a single employer for certain tax rules relating to qualified pension and profit-sharing plans, including top-heavy plans, cafeteria or medical reimbursement plans, group term life insurance plans, and SEPs.

2. TEFRA expands section 414(m) to provide that if an organization's principal business is the performance on a regular and continuing basis of management functions for another organization, whether or not it is a service organization, the person performing the management functions, any person or organization related to the management organization, and the organization for whom the functions are performed are all treated as a single employer.

   a. An organization related to the organization for whom the functions are performed would also be included in the group if management functions are also performed for it on a regular and continuing basis; otherwise, it may be included only in the group with the organization to which it is related under sections 414(b) and (c), which require the aggregation of employers under common ownership.

   b. The term "organization" includes an individual, corporation, partnership, or other entity.

   c. Whether organizations are related is determined under section 103(b)(6)(C).

3. According to the Conference Committee Report, the amendment is intended to apply only when the management functions performed are functions historically performed by employees, including partners or sole proprietors in the case of unincorporated trades and businesses. For this purpose, the present rules relating to affiliated service organizations and to services historically performed by employees in the case of an affiliated service organization are to apply.

N. **Leased Employees** (Code §414(n); TEFRA §248)

1. Under current law, it is possible for an incorporated professional, typically a doctor, a lawyer, or other purveyor of personal services, to maintain qualified plans that cover only the employer-owner by "leasing" clerical and other needed help on a more or less permanent basis. These leased individuals need not be included in the qualified plans of the employers for whom they are working because they are not employees, thereby reducing the cost of maintaining the plans. Effective for taxable years beginning after 1983, the ability to exclude individuals who are leased on a more or less permanent basis has been limited.

2. Under TEFRA, for certain tax rules applying to qualified pension, profit-sharing, and stock bonus plans, including top-heavy plans, and SEPs, a leased employee who performs services for another person — the recipient — may be treated as the recipient's employee when:

   a. 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;

   b. The employee has performed services for the recipient, or for the recipient and persons related to him, on a substantially full-time basis for a period of at least 12 months; and

   c. The services are of a type historically performed by employees in the recipient's business field.

      i. For this purpose, the present rules relating to services historically performed by employees in the case of an affiliated service organization are to apply.

      ii. The employee leasing rules do not apply when services in a particular business field historically have been performed by one person for another.

iii. The Conference Committee Report specifically mentions certain prepaid health care programs that are to be excluded from the leasing rules because of a historical practice.

3. For the purpose of determining whether a qualified plan or a SEP maintained by the recipient satisfies the applicable requirements, the leased employee's years of service for the recipient are determined by taking into account the entire period for which the leased employee performed services for the recipient or a related person.

4. The qualified plan requirements for covered leased employees are those relating to discrimination in eligibility, contributions, and benefits, vesting, and limits on contributions and benefits. Thus, if a recipient's plan would continue to qualify if the leased employees are considered employees without being covered by the plan, the leased employees do not have to be covered.

   a. This provision, therefore, will affect only relatively small employers.

5. Contributions or benefits for the leased employees that are provided by the leasing organization under a qualified plan or a SEP maintained by the leasing organization are to be treated as if provided by the recipient to the extent the contributions or benefits are attributable to services performed by the leased employee for the recipient.

6. According to a safe-harbor provision, an individual who otherwise would be treated as a recipient's employee will not be so treated if certain requirements are met with respect to contributions and benefits provided for the individual under a qualified money purchase pension plan maintained by the leasing organization. The plan must provide that:

   a. The individual is a plan participant on the first day on which he becomes an employee of the employer maintaining the plan;

b. Each employee's rights to, or derived from, employer contributions under the plan are nonforfeitable at the time the contributions are made; and

c. Amounts are to be contributed by the employer on behalf of an employee at a rate of not less than 7½ per cent of the employee's compensation for the year, without integration with Social Security.

7. The Service is authorized to prescribe regulations under which a leased employee will not be treated as the recipient's employee, notwithstanding that the employee leasing provisions might otherwise apply. The Conference Committee Report states that such regulations should be issued when treatment of a leased employee as the recipient's employee is not appropriate, taking into account the purposes underlying the qualified plan rules.

O. Disincorporation Relief (TEFRA §247)

1. Personal service corporations may, under a transitional rule, complete during 1983 or 1984 a one-month liquidation under section 333 without the risk of incurring tax on their unrealized receivables and without regard to whether the corporation is a collapsible corporation under section 341(a). The income represented by the unrealized receivables will retain its character as ordinary income and will be fully recognized by the distributee shareholders upon subsequent collection or other disposition.

2. This provision was enacted in order to provide an inducement to professionals and others who incorporated for pension purposes to disincorporate without fear of incurring substantial adverse tax consequences. Certainly, those corporations that are in danger of being effectively disregarded under new section 269A will want to take advantage of this opportunity to liquidate.

3. Other incorporated professionals may or may not desire to disincorporate. For qualified plan purposes, the incentive to

maintain a corporate practice is no longer there. However, other benefits of incorporation are important. For example, the exclusions for medical benefits under sections 105 and 106 and group term life insurance under section 79 are still available only to corporations. Thus, a corporation can maintain a cafeteria plan under section 125 that includes these benefits while a partnership cannot. Consequently, while unincorporated professionals may not want to incorporate for benefit purposes, it is questionable whether incorporated professionals to whom section 269A is not a problem will want to disincorporate, at least until there is substantial parity for all benefits, qualified and nonqualified.

P. Group Term Life Insurance (Code §79(d); TEFRA §244)

1. Under present law, employees are taxed on the Table I cost of group term life insurance provided by the employer to the extent that the amount of coverage exceeds $50,000 plus the amount paid by the employee. §79. Retired employees may be provided unlimited levels of coverage without tax consequences.

   a. The Table I rates are set by regulations and in past years have been regarded as generally favorable to employees.

   b. Although section 79 does not contain any nondiscrimination requirements, the regulations defining group term insurance achieve a measure of nondiscrimination, particularly for small groups, through the interpretation of the requirements that coverage extend to a "group of employees" and be computed under a formula that "precludes individual selection." *See* Pvt. Letter Rul. 8014003 (Nov. 17, 1979); *Towne v. Commissioner*, 78 T.C. 791 (1982).

2. Effective for taxable years beginning after 1983, a new set of statutory nondiscrimination requirements must be met in order for "key employees" to receive the $50,000 exclusion. A group term life insurance plan is discriminatory if it

discriminates in favor of key employees as to eligibility to participate or the type and amount of benefits available. A failure to follow the new rules will not, however, adversely affect employees who are not key employees.

a. The Table I rates will continue to determine the taxability of even key employees in discriminatory plans. If the group term insurance plan is discriminatory, key employees will be excluded from the first $50,000 of coverage, but their imputed income will be calculated under Table I rates, rather than the higher P.S. 58 rates.

3. The statutory changes do not appear to override the complete exclusion applicable to retired employees or to situations in which the employer or a charity is the beneficiary of the insurance proceeds, even though the coverage discriminates in favor of key employees.

   a. There might be an attempt to "technically correct" the omission of discriminatory coverage for retirees.

4. Unless section 79 is further amended or the new rules receive expansive treatment in regulations, for most companies, the new rules will have little impact other than to force amendment of the plan documents to meet the technical requirements of new section 79(d).

   a. However, any company maintaining disproportionate amounts of group term insurance coverage for management employees will need to look closely to determine whether the plan should be restructured.

5. In general, a key employee is a participant who, during the current or any of the four preceding plan years, was:

   a. An officer, but regardless of title, this category will include not more than the lesser of:

      i. Fifty employees; or

ii. The greater of three employees or 10 per cent of all employees.

b. A stockholder who, directly or through attribution:

i. Is one of the 10 employees who own the most stock of the employer;

ii. Owns as much as five per cent of the stock; or

iii. Owns as much as one per cent of the stock and annually earns more than $150,000.

6. The nondiscrimination requirement is met if:

a. The plan benefits at least 70 per cent of all employees;

b. At least 85 per cent of the plan participants are not key employees;

c. The plan benefits a group that constitutes a "nondiscriminatory classification"; or

d. The plan is part of a cafeteria plan that meets the requirements of section 125.

7. The benefits are nondiscriminatory if all the benefits available to key employees are available to other participants in levels proportionate to the total, basic, or regular rate of compensation.

8. A large publicly held company will rarely have more than 50 key employees, so that a "top-hat" group insurance program that covers 334 executives would seem to qualify under the 85 per cent test of section 79(d) if the benefits are proportionate to the compensation of the covered group, even though no coverage is provided for the rank-and-file employees.

9. Unless an interpretation is adopted that all plans must be treated as a single plan for the purpose of section 79(d), which

would be contrary to existing precedents under other nondiscrimination provisions, apparently companies are able to satisfy the requirements for the $50,000 exclusion by maintaining a basic plan providing $50,000 of coverage for top executives and nondiscriminatory proportionate coverage for other employees, and establishing a separate "top-hat" plan for executives to provide coverage in excess of $50,000. The second plan would be discriminatory but does not seem to be subject to any sanction. The Conference Committee Report does not cast any light on this question.

10. The Conference Committee Report directs the Service to revise the cost tables periodically to reflect current group term life insurance costs. The Service plans to issue revised cost tables that will reflect the lower cost of group term life insurance, thereby reducing the amount of imputed income under section 79 for any plan that does not qualify.

Q. Universal Life Insurance (Code §101(a); TEFRA §266)

1. In recent years, life insurance companies have been marketing flexible premium life insurance contracts, known as "universal life" or "adjustable life" insurance. In some respects, these contracts are similar to traditional whole life policies, but they permit the policyholder to change the amount and timing of the premiums and the size of the death benefit as the policyholder's needs change.

2. Existing law provides that gross income does not include amounts received under a life insurance contract, whether in a single sum or otherwise, if the payment is due to the death of the insured. §101(a). In a January 23, 1981, letter ruling, the Service concluded that the entire amount paid upon the death of the insured under a flexible premium insurance contract is excluded from gross income under section 101(a) as proceeds of a life insurance contract, even though the death benefit reflected a large cash fund and a relatively small amount of pure insurance protection. Recently, the Service announced that it was reconsidering its position on flexible premium life insurance contracts.

3. TEFRA prescribes rules for flexible premium life insurance contracts that will result in the proceeds being excluded from gross income. If the guidelines are not met at any time during the contract term, the contract will not be treated as a life insurance contract for tax purposes.

4. A "flexible premium life insurance contract" is a life insurance contract that:

   a. Provides for the payment of one or more premiums that are not fixed by the insurer as to both timing and amount;

   b. Does not provide any annuity benefits other than as settlement options; and

   c. May contain certain qualified additional benefits such as guaranteed insurability, accidental death benefit, family-term coverage, and waiver of premiums.

5. Death proceeds from eligible contracts will be excluded from gross income only if under the terms of the contract:

   a. The sum of the premiums paid does not at any time exceed the guideline premium limitation and the death proceeds payable are not at any time less than the applicable percentage of the cash value; or

   b. The cash value will not at any time exceed the net single premium for the death benefit at that time without regard to any additional benefits.

6. The guideline premium limitation is the greater of:

   a. The single premium necessary to fund future benefits under the contract, based on mortality and an interest rate of at least six per cent; or

   b. The sum of the level annual premiums over the life of the contract, but not less than 20 years, necessary to fund future benefits, based on mortality and an interest rate of at least four per cent.

c. In addition, three computational rules are to be used in determining a guideline single premium and a guideline level premium.

7. Excessive premium payments, with interest, can be returned to the policyholder within 60 days after the close of the contract year, and otherwise disqualifying premium payments may be made if necessary to prevent a termination of the contract.

   a. The Service is also given discretion to allow the correction of excessive premium payments.

8. The provisions apply to contracts issued before January 1, 1984. Presumably, additional legislation will be enacted covering 1984 and beyond. Any contract issued before 1983 that complies with the new guidelines within one year after the enactment of TEFRA will be treated as being in compliance for all prior periods.

R. Tax-Deferred Annuities (Code §72(e); TEFRA §265)

1. Under existing law, the taxation of interest or other current earnings on a policyholder's investment in an annuity contract — which includes qualified plans — generally is deferred until the annuity payments are received or the amounts characterized as income are withdrawn. A portion of each payment received after the annuity starting date is generally taxed under an exclusion ratio computed to reflect the projected nontaxable return of the investment and the taxable growth on the investment.

   a. For example, amounts paid under an annuity contract before the annuity payments begin, such as payments upon the partial surrender of a contract, are first treated as a return of the policyholder's capital. They are taxable only after all of the policyholder's investment in the contract has been recovered.

2. These rules have been altered for nonqualified plan annuities. Amounts received before the annuity starting date under a

nonqualified annuity contract will be treated first as withdrawals of income earned on investments to the extent of income, with the remainder being treated as a return of capital — a last-in, first-out approach, as opposed to the existing first-in, first-out rule.

a. Loans under an annuity contract or amounts received upon the assignment or pledge of the contract will be treated as amounts received under the contract.

b. The rules for distributions from qualified annuity plans have not been touched.

c. The provisions became effective on August 13, 1982, but do not apply to income amounts allocable to investments made before August 14, 1982.

3. After 1982, premature distributions from a nonqualified annuity contract may be subject to a penalty equal to five per cent of the amount includable in income, to the extent the amount is allocable to an investment made within 10 years of the receipt.

   a. For this purpose, an amount includable in income will be allocable to the earliest investment first.

   b. This penalty will not be imposed if the payment

      i. Is not received before the policyholder reaches age 59½;

      ii. Is made to a beneficiary on or after the death of the policyholder;

      iii. Is attributable to the policyholder becoming disabled;

      iv. Is made under an annuity for life or at least 60 months after the annuity starting date; or

      v. Is allocable to an investment made before August 14, 1982.

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4. Generally, the tax treatment of distributions or withdrawals under life insurance or endowment contracts has not been affected. However, the Service is authorized to issue regulatory guidelines as to when the amount at risk under insurance or endowment contracts is sufficiently minimal so that the contract should be treated as an annuity for the purpose of new section 72(e).

    a. Thus, while the new rules do not appear to affect the cost-recovery type of life insurance contracts that call for consistent borrowing within the guidelines prescribed by section 264, vigilance on this matter would be wise.

S. Miscellaneous Pension Changes (Code §§401, 403(b), and 408(d)(3); TEFRA §§251, 252, and 335)

1. TEFRA substantially revised the section 403(b) tax-sheltered annuity rules as they apply to church employees for taxable years beginning after December 31, 1981. New rules are also provided for qualified state judicial retirement plans. Finally, a governmental retirement plan is allowed to participate in a group trust.

2. Under prior law, qualifying rollover distributions from qualified plans could be rolled over in whole or in part, but distributions from IRAs were only eligible for rollover treatment if the entire amount of the distribution was rolled over to another IRA—or qualified plan, when the original IRA was a rollover IRA. Effective for IRA distributions made after December 31, 1982, partial IRA rollovers are permitted.

    a. Partial distributions from qualified plans, which, by definition, are not qualifying rollover distributions, still may not be rolled over.

T. Employee or Independent Contractor (Code §3509; TEFRA §§269 and 270)

1. Section 530 of the Revenue Act of 1978 provided a safe harbor as to whether a worker was an employee or an independent

contractor. Taxpayers who had a reasonable basis for not treating workers as employees in the past were allowed to continue that treatment without incurring employment-tax liabilities and despite policy changes by the Service. Section 530 relief was available only if the taxpayer filed all federal tax returns, including information returns, on a basis consistent with his treatment of the workers as independent contractors. A prohibition against Treasury Regulations and revenue rulings in this area was also included. These provisions terminated on June 30, 1982.

2. TEFRA extends these provisions indefinitely until Congress has a chance to legislate in the area.

   a. The Senate had adopted rules covering these issues, but the conferees could not reach agreement and the Senate scheme will be considered in a separate bill.

3. TEFRA limits an employer's liability for FICA and income tax withholding when the employer fails to withhold on the mistaken ground that the worker was an independent contractor rather than an employee. The limits are 1.5 per cent of wages paid to the employee for income tax withholding purposes and 20 per cent of the FICA tax that would normally have been due. The liability is doubled to three per cent and 40 per cent respectively when the employer fails to file information returns.

   a. The limitations are inapplicable if the employer has "intentionally disregarded" its responsibilities to withhold.

   b. The limits are effective immediately, but are inapplicable to pre-1983 assessments.

U. **Realty Agents and Direct** Sellers (Code §3508; TEFRA §269)

1. Certain real estate agents and sellers of consumer products not operating in permanent retail establishments, like door-to-door salesmen, are to be treated as independent contrac-

tors when services performed after December 31, 1982, are provided pursuant to written contracts specifying that they are not employees for federal employment tax purposes.

V. FUTA Increases and Exclusions (Code §3306; TEFRA §§271, 276, and 277)

1. The FUTA wage base ceiling has been raised to $7,000 from $6,000 and the tax rate has been raised to 3.5 per cent from 3.4 per cent and is scheduled to increase to 6.2 per cent in 1985 and thereafter. Adjustments are also made to the credit for payments to state unemployment programs.

   a. The increases apply to remuneration paid after December 31, 1982.

2. Other provisions expanded, as of the date of enactment, the FUTA exclusion for certain full-time students and continued the exclusion for certain alien farmworkers.

W. Withholding for Inaccurate Identification Number (Code §3402; TEFRA §317)

1. A new provision requires a flat 15 per cent withholding on "backup withholding payments" when the payee has:

   a. Failed to furnish the payor a TIN or has supplied an "obviously incorrect" one with an improper number of digits; or

   b. The Service notifies the payor that the number furnished by the payee is incorrect.

2. Withholding is required on any backup withholding payment made during the period in which no TIN other than an obviously incorrect one has been furnished. When the Service notifies the payor that the TIN is incorrect, withholding applies 15 days after notification and until the payee furnishes the payor another TIN.

a. Both periods are extended by 15 days after their close unless the payor elects otherwise.

b. A payor may elect to withhold during the 15-day period following notification by the Service that a payee has furnished an incorrect number.

c. When a payee is guilty of providing two incorrect TINs, withholding is to continue until the Service notifies the payor that a correct TIN has been furnished. The 15-day grace period before withholding must stop following the correction of the TIN would probably also apply in this instance.

3. Although this provision amends the wage withholding provisions of section 3402, it is not limited to income tax withholding on wages. "Backup withholding payments" cover amounts not otherwise subject to withholding, including wages, rents, interest, annuities, certain foreign payments, payments to furnishers of services and direct sellers who are treated as independent contractors, corporate dividends, patronage dividends, payments by brokers, and payments by certain fishing boat operators.

4. A $600 annual minimum payment is required before this withholding is imposed as to certain payments such as wages.

5. Payments to the United States or a state, exempt and international organizations, or foreign governments, as well as to persons specified by regulation, are exempted from this withholding.

6. The payor is required to give notice to the payee and the Service.

7. The provision applies to payments made after December 31, 1983.

X. Returns on Magnetic Tape (Code §6011; TEFRA §319)

1. At present, returns need not be filed on magnetic tape or in

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other machine-readable form. TEFRA requires the Service to develop regulations that will provide standards for determining which returns must be filed on magnetic media or in other machine-readable form. In setting these standards, the Service must take into account, among other relevant factors, the ability of the taxpayers to comply at a reasonable cost with a filing requirement.

a. The requirement is not to be placed on individuals, estates, and trusts. It is likely to be imposed, however, on plan administrators or employers with respect to information on the tax status of distributions from qualified plans.

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