1988

Employee Plans, What to do in 1989

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I. CHANGES TO TAX-QUALIFIED RETIREMENT PLANS

A. Amendments. Virtually all tax-qualified retirement plans will have to be amended to comply with changes made by the Tax Reform Act of 1986 ("TRA-86"). In many cases, the effective dates noted below are extended if the plan is maintained pursuant to a collective bargaining agreement ratified before a particular date.

B. Limit on Compensation. TRA-86 limits to $200,000 the amount of a participant's compensation that may be taken into account for purposes of a qualified plan. This $200,000 limit will be increased for cost of living adjustments. This change is effective for plan years beginning on or after January 1, 1989. I.R.C. §401(a)(17); I.R.C. §404(l).

C. Profit Sharing Plan Contributions. A profit sharing plan is no longer required to provide that contributions may only be made if the employer has current or accumulated net profits. Contributions may be made regardless of the employer's profits. This change is effective for plan years beginning on or after January 1, 1986. I.R.C. §401(a)(27).

D. Vesting.

1. TRA-86 imposes new minimum vesting schedules on qualified plans. A plan's vesting schedule may not be longer than one of the following schedules:

Years of Service	Vested Percentage
Less than 5 years	0%
5 years or more	100%

OR

Years of Service	Vested Percentage
Less than 3 years	0%
3 years	20%
4 years	40%
5 years	60%
6 years	80%
7 years or more	100%

This change is effective for participants who have at least one hour of service in a plan year beginning on or after January 1, 1989. I.R.C. §411(a).

2. The stricter vesting provisions for top heavy plans have not been changed.

E. Integration with Social Security. The rules for integrating a qualified plan with Social Security have been tightened.

1. Under a defined contribution plan, the excess contribution percentage cannot exceed the base

contribution percentage by more than the lesser of (i) the base contribution percentage or (ii) the greater of 5.7% or the OASDI tax rate for the year (presently 5.7%). The "excess contribution percentage" is the percentage of compensation that is contributed with respect to compensation above the integration level. The "base contribution percentage" is the percentage of compensation that is contributed with respect to compensation at and below the integration level. This change is effective for plan years beginning on or after January 1, 1989. I.R.C. §401(l).

2. The integration rules for defined benefit plans have also changed, is effective for plan years beginning on or after January 1, 1989. I.R.C. §401(l).

   (a) Under an excess plan, the excess benefit percentage may not exceed the base benefit percentage by more than the "maximum excess allowance". The maximum excess allowance is (i) in the case of benefits attributable to any one year of service, 3/4 of a percent and (ii) in the case of total benefits, 3/4 of a percent, multiplied by the participant's years of service (not in excess of 35). The maximum excess allowance may not exceed the base benefit percentage. In addition, any optional form of benefit, pre-retirement benefit, actuarial factor or other benefit or feature provided with respect to compensation in excess of the integration level must also be provided with respect to compensation below the integration level. Benefits must be based on average annual compensation.

(b) In the case of an offset plan, a participant's accrued benefit may not be reduced (by reason of the offset) by more than the "maximum offset allowance", and benefits must be based on average annual compensation. The maximum offset allowance is (i) in the case of benefits attributable to any one year of service, 3/4 of a percent of the participant's final average compensation and (ii) in the case of total benefits, 3/4 of a percent of the participant's final average compensation, multiplied by the participant's years of service (not in excess of 35). The maximum offset allowance may not exceed 50% of the benefit that would have accrued without regard to the offset reduction.

F. Contribution and Benefit Limits. TRA-86 made several modifications to the I.R.C. §415 benefit and contribution limits, effective for plan years beginning on or after January 1, 1987. Among other changes, all employee contributions are now considered "annual additions" for purposes of these limits. I.R.C. §415(b) and (c).

G. Section 401(k) Plans and Savings Plans.

1. TRA-86 changed the annual tests that pre-tax contributions to an I.R.C. §401(k) plan must meet. The new provision requires that one of the following tests be met each year:

   (a) The actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 1.25, OR

   (b) The excess of the actual deferral percentage for the group of highly compensated employees over that of all other eligible employees is not more than 2 percentage points, and the actual deferral percentage for the group of highly compensated employees is not more than the actual deferral percentage of all other eligible employees multiplied by 2.

The actual deferral percentage for a group of employees is the average of the ratios (calculated separately for each eligible employee in the group) of the employee's pre-tax contributions to the employee's compensation for the year. This change is effective for plan years beginning on or after January 1, 1987. I.R.C. 401(k)(3).

2. TRA-86 imposes similar tests for after-tax employee contributions and matching contributions, effective for plan years beginning on or after January 1, 1987. I.R.C. §401(m).

3. If a plan does not meet these new anti-discrimination tests for a plan year, the excess contributions and related earnings must be distributed within 2-1/2 months after the end of the plan year in order to avoid having a 10% excise tax imposed on the employer. I.R.C. §4979.

4. TRA-86 imposes a $7,000 annual limit (adjusted for 1988 to $7,313) to the amount of pre-tax contributions that a participant may make to an I.R.C. §401(k) plan. This change is effective for calendar years beginning on and after January 1, 1987. I.R.C. §402(g).

H. Uniform Commencement Dates. Under TRA-86, as a general rule, all participants must begin receiving plan distributions by the April 1 after the year in which they attain age 70-1/2, regardless of whether the participants have retired. These rules are effective for tax years beginning on or after January 1, 1989. I.R.C. §401(a)(9).

I. Plan Loans.

1. The limit on the maximum amount that a participant can borrow from a qualified plan has been modified. In order for a plan loan not to be considered a taxable distribution to the participant, the aggregate loans to the participant from the employer's qualified plans may not exceed the lesser of:

   (a) $50,000, reduced by the excess (if any) of

      (i) the highest outstanding balance of plan loans to the participant during the one-year period ending on the day before the date on which the loan was made, over

      (ii) the outstanding balance of plan loans on the date on which the loan was made,

   OR

   (b) The greater of

      (i) one-half of the present value of the participant's vested accrued benefit under the plan or

      (ii) $10,000.

2. Plans must provide for substantially level amortization of loan payments, and loan repayments must be made at least quarterly. The period for repayment of a loan can exceed five years only if the loan is used to acquire the participant's principal residence.

3. A key employee may no longer deduct interest on a loan from a qualified plan. Other participants may only deduct interest according to the general TRA-86 rules for deduction of interest. No participant may deduct interest on a loan made from pre-tax contributions to an I.R.C. §401(k) plan.

4. These changes are effective for loans made, renewed, renegotiated, modified or extended after December 31, 1986. I.R.C. §72(p).

J. Participation. TRA-86 imposes a new participation rule that was intended to prevent employers from having qualified plans covering only a small number or percentage of employees.

1. TRA-86 provides that each qualified plan must benefit at least the lesser of (i) 50 employees or (ii) 40% of the employees of the employer's controlled group. Plans may not be aggregated for this purpose. This change is effective for plan

years beginning on or after January 1, 1989. I.R.C. §401(a)(26).

2. If a defined benefit pension plan that was in existence on August 16, 1986 is required to be terminated because of this new participation requirement, the plan will not be subject to the new 10% tax on reversions from a pension plan. This exception only applies if the plan would fail to meet the requirements of I.R.C. §401(a)(26) if that Section were in effect for the plan year including August 16, 1986 and there is no transfer of assets to or liabilities from the plan or any merger or spinoff involving the plan after August 16, 1986. The termination must occur before the first year to which I.R.C. §401(a)(26) applies. See IRS Notice 87-36, describing the interest rates that must be used to compute benefits when such a plan is terminated and the tax consequences to participants. TRA-86 §1112(e)(3).

3. The effective date of I.R.C. §401(a)(26) may be delayed if the plan is prohibited from terminating under Title IV of ERISA. TRA-86 §1112(e)(3).

K. <u>Coverage</u>. TRA-86 tightens the coverage requirements that a qualified plan must meet.

1. The new rules provide that one of the following requirements must be met:

   (a) The plan benefits at least 70% of the employees who are not highly compensated employees.

   (b) The plan benefits a percentage of non-highly compensated employees that is at least 70% of the percentage of highly compensated employees benefitting under the plan.

   OR

   (c) The plan benefits employees under a classification that the Secretary of the Treasury finds not to be discriminatory in favor of highly compensated employees and the average benefit percentage for non-highly compensated employees is at least 70% of the average benefit percentage for highly compensated employees. The average benefit percentage is the average of the benefit percentages calculated separately with respect to each employee in the group (whether or not a participant in any plan). An employee's benefit percentage is the employer-provided contribution or benefit under all qualified plans maintained by the employer, expressed as a percentage of the participant's compensation.

2. For purposes of these coverage tests, the following employees may be excluded:

   (a) Employees who are covered by a collective bargaining agreement may be excluded if retirement benefits are the subject of good faith bargaining.

   (b) Non-resident aliens who have no U.S. source of income may be excluded.

   (c) If a plan prescribes minimum age and service requirements as a condition of participation and excludes all employees not meeting those requirements from participation, then those employees may be excluded.

3. If certain requirements are met, the minimum coverage requirements may be applied separately to a separate line of business of the employer.

4. These changes are effective for plan years beginning on or after January 1, 1989. I.R.C. §410(b).

L. <u>10% Excise Tax on Reversions</u>. TRA-86 imposes a new 10% excise tax on amounts that revert to an employer upon the termination of a defined benefit pension plan. This change is generally effective for reversions occurring after December 31, 1985. However, the new excise tax does not apply to a reversion after December

31, 1985 that occurs pursuant to a plan termination before January 1, 1986. I.R.C. §4980.

M. Excise Tax on Non-Deductible Contributions. TRA-86 imposes a new 10% excise tax on non-deductible contributions made to a qualified plan. This change is effective for tax years beginning on or after January 1, 1987. I.R.C. §4972.

N. Quarterly Contributions. The Omnibus Budget Reconciliation Act of 1987 (OBRA-87) requires that an employer make quarterly contributions to a defined benefit pension plan, effective for plan years beginning on or after January 1, 1989. Special transition rules apply for plan years beginning in 1989 through 1991. The statute, by its terms, also applies to money purchase pension plans, although this result may have been unintended and should be corrected by technical corrections. I.R.C. §412(m).

O. Age Discrimination.

1. Amendments to the Age Discrimination in Employment Act prohibit an employer from requiring that employees retire at a stated age. The provisions that previously permitted mandatory retirement at age 70 have been repealed, effective as of January 1, 1987.

2. A retirement plan may no longer cease benefit accruals when a participant attains his normal retirement date. Plans must now continue accruals for participants who continue to work past normal retirement date.

3. A retirement plan may no longer exclude employees who are hired within five years before the plan's normal retirement date. However, the plan's normal retirement date can be changed to be the later of age 65 or five years after the employee becomes a participant.

4. These retirement plan changes are effective for plan years beginning on or after January 1, 1988 and apply only to participants who have an hour of service on or after the effective date. I.R.C. §§410(a)(2), 411(a)(8), 411(b)(1)(H), 411(b)(2)(A).

5. The Internal Revenue Service has taken the position in proposed regulations under I.R.C. §410 and §411 that these changes generally require an employer to give past service credit for purposes of benefit accrual under a defined benefit plan for service before the effective date of the changes.

P. Deduction Limits.

1. OBRA-87 imposes several new restrictions and requirements on contributions to defined benefit pension plans. Among these restrictions are stricter new full funding limitations that will limit the deductible contributions that may be made to a fully funded defined benefit plan. These changes are effective for tax years beginning on or after January 1, 1988. I.R.C. §412(c)(7).

2. If an employer maintains a defined benefit pension plan and a defined contribution pension plan, the employer may not contribute to the two plans more than the greater of (i) 25% of participants' compensation or (ii) the amount required to be contributed to the defined benefit plan to satisfy the minimum funding standard for that plan. This change is effective for tax years beginning on or after January 1, 1987. I.R.C. §404(a)(7).

Q. Optional Forms of Benefits and Employer Discretion.

1. The Treasury has issued final regulations under I.R.C. §401(a)(4) and §411(d)(6) relating to optional forms of benefit and employer discretion in qualified plans. As an example, an employer generally may no longer exercise discretion as to

the time or form of payment of benefits from a qualified plan.

2. The regulations are generally effective as of January 30, 1986. The regulations have a delayed effective date for certain existing plans that do not comply with the new rules. For certain existing plans, the regulations are effective as of the first day of the first plan year beginning on or after January 1, 1989. An existing plan that has employer discretion with respect to an optional form of benefit and that falls within the delayed effective date provision generally can be amended to eliminate the optional form of benefit without violating the Internal Revenue Code's anti-cutback rules. The amendment must be made within the time period for making TRA-86 amendments. However, the plan must be administered in accordance with the regulations for plan years beginning on or after January 1, 1989. Treas. Reg. §1.401(a)-4; Treas. Reg. §1.411(d)-4.

II. 15% EXCISE TAX ON SUBSTANTIAL DISTRIBUTIONS FROM QUALIFIED PLANS AND IRAs.

A. Excise Tax on Annual Distributions. TRA-86 imposes a new 15% excise tax on substantial distributions from qualified plans and IRAs. The tax applies to the portion of an annual distribution that exceeds the greater of (i) $150,000 or (ii) $112,500, adjusted for cost of living adjustments. If a participant receives a lump sum distribution and elects 10-year or 5-year income averaging, the limit is five times the otherwise applicable limit (that is $750,000 instead of $150,000).

B. Estate Tax. If a participant dies with substantial accumulations in his qualified plans and IRAs, a new estate tax will be imposed on the portion of the accumulations in excess of a designated amount. This designated amount is the present value of a term-certain annuity, based on the participant's life expectancy immediately before his death, equal to the greater of (i) $150,000 a year or (ii) $112,500 a year, adjusted for cost of living adjustments. This new estate tax is not subject to any estate tax credits or the marital deduction. The $112,500 amount has been adjusted to $117,529 for 1988. Attached is a table showing the present value of annuities of $117,529 and $150,000, based on a participant's life expectancy at ages 65 to 80.

C. <u>Grandfather Election</u>. A participant may elect to "grandfather" the accumulations in his IRA and qualified plan accounts as of August 1, 1986, if those accumulations were at least $562,500 as of August 1, 1986. This election must be made on the participant's income tax return for 1986, 1987 or 1988. The Treasury has issued temporary regulations specifying the way the grandfathered benefits will be prorated as distributions are made. If the grandfather election is made, the participant's annual limit will be $112,500, adjusted for cost of living adjustments, and not $150,000.

D. <u>Effective Date</u>. These changes are generally effective for distributions made after December 31, 1986 and to persons dying after December 31, 1986. I.R.C. §4981A.

III. WELFARE PLANS

A. Documentation Requirements.

1. TRA-86 imposes five requirements that welfare plans must meet:

   (a) The plan must be in writing.

   (b) Employees' rights under the plan must be legally enforceable.

   (c) Employees must be given reasonable notice of the benefits available under the plan.

   (d) The plan must be maintained for the exclusive benefit of employees.

   (e) The plan must be established with the intention of being maintained for an indefinite period of time.

2. These plan document requirements apply to the following types of welfare plans maintained for its employees:

   (a) Group term life insurance that is subject to I.R.C. §79.

   (b) Accident and health plans.

   (c) Cafeteria plans.

   (d) Other plans specified in I.R.C. §89(k) and §89(i).

This change is effective for plan years beginning on or after January 1, 1989. I.R.C. §89(k).

B. Non-Discrimination Rules.

1. TRA-86 imposes complex new non-discrimination rules on health and life insurance plans for employees. If these non-discrimination rules are not met, the highly compensated employees covered under the plan must include in income the value of the discriminatory portion of their benefits. I.R.C. §89(a). The employer must report this amount to the employees and the I.R.S. on Form W-2.

2. The discrimination tests require that all the following requirements be met or that the alternate test in paragraph 3 below be met. The "long-form" test (I.R.C. §89(d) and (e)) is as follows:

   (a) At least 90% of all non-highly compensated employees (i) are eligible to participate in a plan of the type being tested and (ii) are eligible to receive employer-provided benefits equal in value to at least 50% of the value of the largest employer-provided benefit available to any highly compensated employee. This test is performed by aggregating all plans of the employer.

   (b) At least 50% of the employees eligible to participate in the plan are not highly compensated employees or the percentage of non-highly compensated employees eligible to participate in the plan is at least equal to the percentage of highly compensated employees eligible to participate in the plan. Comparable plans can be aggregated for purposes of this test.

(c) The plan does not contain any provision that, by its terms or otherwise, discriminates in favor of highly compensated employees.

(d) The average employer-provided benefit received by non-highly compensated employees under all plans of the same type is at least 75% of the average employer-provided benefit received by highly compensated employees. The average employer-provided benefit received by each group is determined by dividing the aggregate employer-provided benefits of the group by the number of employees in the group, whether or not they are covered by the plans. This test is performed by aggregating all plans of the same type.

3. Alternate Test. As an alternative, a plan will be considered non-discriminatory if it meets the following requirements (I.R.C. §89(f)):

(a) The plan covers at least 80% of the non-highly compensated employees. Comparable plans may be aggregated for purposes of this test.

(b) The plan does not contain any provision that, by its terms or otherwise, discriminates in favor of highly compensated employees.

4. The term "highly compensated employee" means an employee who, during the year or the preceding year:

   (a) Was a five percent owner of the employer.

   (b) Received compensation from the employer in excess of $75,000 a year.

   (c) Received compensation from the employer in excess of $50,000 a year and was in the top paid 20% of the employer's employees.

   (d) Was an officer and received compensation from the employer in excess of $45,000 a year (150% of the I.R.C. §415(c)(1)(A) dollar limitation).

   I.R.C. §414(q).

5. I.R.C. §89(h) permits the following employees to be excluded for testing purposes, with certain important exceptions:

   (a) Employees who normally work fewer than the lesser of (i) 17-1/2 hours per week or (ii) the fewest number of hours required to participate in any plan of the type being tested.

   (b) Employees who normally work during fewer than the lesser of (i) six months per year or (ii) the fewest number of months per year required to participate in any plan of the type being tested.

(c) Employees who have completed less than the lesser of (i) 12 months of service or (ii) the fewest number of months of service required to participate in any plan of the type being tested.

(d) Employees who have not attained the lesser of (i) age 21 or (ii) the youngest age required to participate in any plan of the type being tested.

(e) Employees covered by a collective bargaining agreement if the benefits have been subject to good faith bargaining and if (unless modified by regulations) no employees covered by a collective bargaining agreement are eligible to participate in any plan of the type being tested.

(f) Non-resident aliens with no U.S. source of income.

6. If certain requirements are met, an employer may apply the non-discrimination tests separately for each separate line of business as long as the plans are available to a non-discriminatory classification of employees. I.R.C. §89(g)(5).

7. These changes are generally effective for plan years beginning on or after January 1, 1989.

AMOUNT OF LUMP SUM DEATH BENEFIT

NOT SUBJECT TO 15% ESTATE TAX

AGE (1988)	FACTOR	MULTIPLE OF $117,529	MULTIPLE OF $150,000
65	6.7970	$798,845	$1,019,550
66	6.6551	782,167	998,265
67	6.5098	765,090	976,470
68	6.3610	747,602	954,150
69	6.2086	729,691	931,290
70	6.0522	711,309	907,830
71	5.8914	692,410	883,710
72	5.7261	672,983	858,915
73	5.5571	653,120	833,565
74	5.3862	633,035	807,930
75	5.2149	612,902	782,235
76	5.0441	592,828	756,615
77	4.8742	572,860	731,130
78	4.7049	552,962	705,735
79	4.5357	533,076	680,355
80	4.3659	513,120	654,885