Employee Benefits Legislation- Another Round: The Tough Get Tougher

Mark S. Dray
EMPLOYEE BENEFITS LEGISLATION--ANOTHER ROUND: THE ‘TOUGH GET TOUGHER

By

Mark S. Dray
Hunton & Williams
Richmond, Virginia
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I. Background

A. Fairness, simplicity, efficiency and fraud!

B. The shifting tax equation
   1. Current deductions
   2. Tax-free buildup on reserves
   3. Favorable distribution rules
   4. Individual and corporate rate differentials

II. Individual Retirement Accounts

A. Deductible contributions
   1. Effective dates
      a. Taxable years commencing in 1986--no change
      b. New rules apply for taxable years beginning after December 31, 1986
   2. Deduction limit
      a. The lesser of (i) $2,000 or (ii) 100% of compensation or earned income. § 219(b)
   3. Who may take deduction?
      a. Any individual who--
         i. is not an "active participant" in an employer-maintained plan
(or, in the case of a married individual, neither the individual nor the spouse is an active participant); or

ii. has adjusted gross income ("AGI") that does not exceed the "applicable amount"

4. Who is an "active participant"?

a. Any individual (or the spouse of a married individual) who for any part of any plan year ending with or within a taxable year of such individual(s) is a participant in a qualified plan, an annuity plan, a governmental plan, a tax-sheltered annuity plan, a simplified employer pension plan or certain employee pay-all pension plans, is deemed to be an active participant in such plan for the taxable year. §§ 219(g)(5)(A) and (B).

b. Participation in a § 457 eligible deferral election plan does not make one an "active participant" for this purpose. § 219(g)(5).

c. See generally Reg. § 1.219-2 as to what constitutes active participation under different types of plans.

d. Vesting or nonforfeitable rights are irrelevant. § 219(g)(5).

5. The "active participant" exception

a. Taxpayers with AGIs of less than the following "applicable amounts" may make a deductible individual retirement account ("IRA") contribution even if an active participant.
   
i. $25,000, for single individuals,

   ii. $40,000, for married taxpayers filing a joint return, and

   iii. $0, for married taxpayers filing separately.
   § 219(g)(3)(B).

b. If AGI exceeds the "applicable amount" by $10,000 or less, the individual may make a reduced deductible IRA contribution in accordance with the following table.(1) § 219(g)(2).

<table>
<thead>
<tr>
<th>AGI Individual</th>
<th>AGI Joint Return</th>
<th>Deductible IRA Dollar Limit</th>
</tr>
</thead>
<tbody>
<tr>
<td>$25,000</td>
<td>$40,000</td>
<td>$2,000</td>
</tr>
<tr>
<td>26,000</td>
<td>41,000</td>
<td>1,800</td>
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<tr>
<td>27,000</td>
<td>42,000</td>
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</tr>
<tr>
<td>29,000</td>
<td>44,000</td>
<td>1,200</td>
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<td>30,000</td>
<td>45,000</td>
<td>1,000</td>
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<tr>
<td>31,000</td>
<td>46,000</td>
<td>800</td>
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<tr>
<td>32,000</td>
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<td>33,000</td>
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<tr>
<td>34,000</td>
<td>49,000</td>
<td>200</td>
</tr>
<tr>
<td>35,000</td>
<td>50,000</td>
<td>200</td>
</tr>
</tbody>
</table>

6. Qualified voluntary employer contributions may no longer be made to a qualified plan. § 219(e).

B. Nondeductible contributions

1. Effective for taxable years beginning after December 31, 1986, individuals who may not make a fully deductible IRA contribution may make nondeductible contributions to an IRA. § 408(o).

2. Basically, the nondeductible IRA contribution limit is the maximum deductible IRA contribution limit reduced by any deductible IRA contributions claimed.

3. Individuals may designate the amount of their deductible and nondeductible IRA contributions within the applicable limits.

C. Spousal IRAs

1. Both deductible and nondeductible additional aggregate $250 spousal IRA contributions are available.

2. The requirement that the spouse have "no compensation" is removed for taxable years beginning after December 31, 1985, if the spouse elects to be treated as having no compensation for the year. § 219(c)(1)(B).

3. If either spouse is an active participant, then neither can make a deductible IRA contribution unless their AGI is less than $50,000.

4. The $250 additional deductible spousal IRA contribution limitation also is proportionately reduced where the taxpayer's AGI exceeds $40,000. § 219(g)(1).
III. New Qualified Plan Rules

A. Coverage

1. The alternatives

   a. Generally, effective for plan years beginning after December 31, 1988, a qualified retirement plan must satisfy one of the following three coverage tests.

      i. The new "percentage test." The plan covers at least 70% of all non-highly compensated employees. § 410(b)(1)(A).

         a. Generally, all participants actually participating or eligible to participate will be deemed to benefit. §§ 401(a)(26)(C); 410(b)(2)(E).

      ii. The "ratio test." Under the new classification test, the coverage percentage of non-highly compensated employees must be at least 70% of the coverage percentage of highly compensated employees. § 410(b)(1)(B).

      iii. The "average benefit percentage test." Under this test, a plan that satisfies the "reasonable classification" test of prior law (using the new definition of "highly compensated") will satisfy this test if the "average benefit percentage" for non-highly compensated employees is at least 70% of the average benefit percentage for highly compensated employees. § 410(b)(2)(A).
a. The average benefit percentage for a group of employees is the average of each employee's "benefit percentage." § 410(b)(2)(B).

b. An employee's "benefit percentage" is the employer-provided contributions (including elective deferrals and forfeitures) or benefits provided for the employee under all qualified plans maintained by the employer, expressed as a percentage of the employee's compensation. § 410(b)(2)(C).

c. All benefits or contributions must be converted to the applicable testing measure.

d. The § 415 compensation definition is to be used for this purpose as limited by § 410(a)(17), i.e., currently a $200,000 maximum.

e. Disparities permitted under the new social security integration rules may be taken into account under this test. Conf. Rep. at II-413.

f. Individuals not covered by an employer plan are deemed to have a benefit percentage of zero. § 410(b)(2)(E).
g. The calculation takes into account projected rather than accrued benefits.

h. An employer may select the period to be used to determine average benefit percentages. § 410(b)(2)(C).

i. The Conference Agreement also directs the Secretary of Treasury to modify Rev. Rul. 81-202, 1981-2 C.B. 93, which is used to determine whether contributions and benefits are "comparable." Conf. Rep. at II-413.

2. Coverage calculation exceptions

a. As under present law, individuals who do not meet the minimum age or service requirements prescribed by the plan or who are covered by a bona fide collective bargaining agreement under which there is evidence of good faith bargaining for retirement benefits and certain non-resident aliens and certain airline employees may be disregarded for purposes of this testing. § 410(b)(3).

b. The control group rules of §§ 414(b) and (c) and the affiliated service group rules of § 414(m) apply.

c. New special disposition or acquisition rules.

d. Line of business exceptions. Certain lines of business or operating units maintained for bona fide business reasons may be tested separately. These rules are
extremely complex, fact intensive and designed to assure an employer is not able to get around the applicable nondiscrimination in coverage rules. § 414(r).

e. As in the past, the coverage rules must be satisfied on at least one day of each calendar quarter.

3. Highly compensated employees

a. "Highly compensated employee" means an employee who, during the current year or prior year, falls into one of the following four categories:

i. a 5% owner;

ii. received compensation from the employer greater than $75,000;

iii. received compensation from the employer greater than $50,000 and in the "top-paid group" (i.e., the highest paid 20% of employees) with certain exclusions described below;

iv. an officer having compensation greater than $45,000 (this amount is tied to 150% of the defined contribution limit then in effect). No more than 50 officers are counted.

b. Special one-year lookback rule for current year

i. If an employee is in category a.ii., iii., or iv. for the current year but he was not in category a.ii., iii., or iv. for the preceding year, he is not treated as a highly compensated employee for the current year unless he is in
the top 100 highest-paid employees for the current year.

ii. If any employee is not a 5% owner or in the top 100 employees by compensation for the current year and he did not fit in any of the 4 categories of highly compensated employees in the preceding year, then he is not treated as highly compensated for the current year. If he falls into categories a.ii., iii., or iv. for the current year, but he is not treated as a highly compensated employee (because of the one-year lookback and the top 100 employee rule), he will be treated as a highly compensated employee for the following year.

a. Example: In 1987 John Smith is hired as an officer of the company. He receives $60,000 compensation. He did not work for an affiliate or subsidiary of the company in 1986. More than 100 other employees receive higher compensation than John Smith. He is in the top-paid group and fits category iii., but he is not in the top 100 highest paid employees. Therefore, he is not treated as a highly compensated employee for 1987.

In 1988 his compensation increases to $70,000. He is in the top-paid group again and again he fits
category iii. He is a highly compensated employee for 1988.

c. Top-paid group

i. The top-paid group means the top 20% of the employees ranked in order of compensation during the year. Only active employees are counted. Former employees are disregarded.

ii. To determine the number of employees in the top-paid group (but not the individual employees in the top-paid group), the following employees may be excluded:

a. New hires. Employees with less than 6 months of service.

b. Part-timers. Employees who normally work less than 17½ hours a week.

c. Seasonals. Employees who normally work 6 months or less.

d. Younger employees. Those who have not reached age 21.

e. Union. Employees covered by a collective bargaining agreement.


iii. Exclusions c.ii., b., c., and d. may be applied by an employer by substituting a
smaller period of service, a smaller number of hours or months, or a lower age. Any substitution must be consistently applied in determining the top-paid group for all benefits.

a. Example: Assume a calendar year employer has 3,000 employees in 1988 and 1989 and for each year 600 employees may be disregarded in determining the number of employees in the top-paid group. Therefore, the number of employees in the top-paid group is 480 (20% x 2,400).

This employer's highly compensated employees for 1989 include the following:

i. Any employee who in 1988 or 1989 was a 5% owner of the employer.

ii. Any employee who, in 1988,

   (a) received more than $75,000 in compensation,

   (b) was an officer who received more than $45,000 in compensation (and fit in the number limitations, e.g., 50 officers), or
(c) received more than $50,000 in compensation and was among the 480 highest paid employees (i.e., the top-paid group).

iii. Any employee, who in 1989, was among the 100 highest paid employees and either

(a) was an officer who received more than $45,000 in compensation (and fit in the number limitations, e.g., 50 officers), or

(b) received more than $50,000 in annual compensation.

Therefore, if in 1988, an employee does not fit any of the four categories of highly compensated employees, he will not be treated as a highly compensated employee for 1989 unless the employee either:

(c) acquires more than a 5% ownership in the employer in 1989, or
(d) both (a) becomes one of the top 100 most highly compensated employees for 1989, and (b) either becomes an officer (with compensation greater than $45,000) or receives more than $50,000 in compensation in 1989.

4. Special rule for certain family members

a. If an individual is a member of the family of a 5% owner or of a highly compensated employee who is in the group of the ten highest compensated employees during the year, the individual is not considered a separate employee and any compensation paid to the individual (and any benefit or contribution made on his behalf) is treated as if paid to or received on behalf of the 5% owner or highly compensated employee.

b. A family member of an employee means the employee's spouse and lineal ascendants (parents) or descendants (children, grandchildren) and the spouses of such lineal ascendants or descendants (in-laws).

5. Compensation

a. Compensation means an employee's compensation for purposes of the limitations on benefits and contribution under § 415, plus
i. salary-reduction amounts under a cafeteria plan, and

ii. salary deferrals under a qualified cash or deferred arrangement that is part of a qualified plan under § 401(k), a § 403(b) annuity, or a simplified employee pension.

6. Special rule for former employees

a. A former employee is treated as a highly compensated employee if he was a highly compensated employee (a) when he separated from service or (b) at any time after he attained age 55. Treasury regulations are to establish rules treating an employee who performs only de minimis services as separated from service for purposes of determining whether he is a highly compensated employee. These rules are to preclude an employee from attempting to avoid being treated as a highly compensated employee because he continues to perform a small amount of services for the employer after retirement and claims he has not separated from service.

B. Participation

1. Effective for plan years beginning after December 31, 1988, a retirement plan will not be qualified unless it benefits at least 50 employees, or, if less, 40% of all employees of the employer on each day of the plan year. § 401(a)(26).

a. This requirement may not be satisfied by aggregating plans.

b. Generally, the various rules applicable in determining compliance
with the coverage rules are applicable here.

c. Wasting trusts also must comply; existing plans may not simply be "frozen" to satisfy this requirement. Conf. Rep. at I-381.

d. A cash or deferred arrangement and the plan that contains it, i.e., a § 401(k) plan may no longer require more than one year of service as a condition of participation.

e. Plans (other than plans containing cash or deferred arrangements) may not require more than 2 years of service as a condition of participation even though the plan provides full and immediate vesting. § 410(a)(1)(B).

C. Vesting

1. Generally, effective with respect to participants with one hour of service in plan years beginning after December 31, 1988, one of the following two alternative vesting schedules must apply.

   b. Seven-year graded.

<table>
<thead>
<tr>
<th>Years of Service</th>
<th>Vested Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>Less than 3</td>
<td>0%</td>
</tr>
<tr>
<td>3</td>
<td>20%</td>
</tr>
<tr>
<td>4</td>
<td>40%</td>
</tr>
<tr>
<td>5</td>
<td>60%</td>
</tr>
<tr>
<td>6</td>
<td>80%</td>
</tr>
<tr>
<td>7</td>
<td>100%</td>
</tr>
</tbody>
</table>

2. A ten-year cliff vesting schedule is still available for certain collectively-bargained multiemployer plans. § 411(a)(2)(C).
3. Under the new rules, participants with 3 years of service will have the election to remain under the existing vesting formula on the change of a formula.

4. The "top-heavy" 3- and 6-year vesting schedules are not changed.

D. Includable compensation

1. Generally, for plan years beginning after December 31, 1988, compensation is defined as total compensation includable in gross income. § 414(s).
   
   a. An employer will generally be able to elect to have salary-reduction contributions to cafeteria plans and cash or deferred arrangements included for all purposes except for purposes of determining who is highly compensated. Conf. Rep. at II-416.

2. The maximum amount of compensation that may be taken into account, however, is $200,000. § 401(a)(17).
   
   a. Beginning in 1990, this $200,000 limit will be adjusted to reflect post-1986 cost-of-living increases measured by the CPI.

E. Tighter integration rules

1. Generally, the new integration rules apply for plan years beginning after December 31, 1988. §§ 401(a)(4) and 401(l).
   
   a. In addition to establishing new rules for measuring social security contributions or benefits, the new rules reduce the permitted disparity in the level of benefits provided "highly compensated" and "non-highly compensated" folks.
2. Defined benefit plans
   a. The permitted disparity in the "excess benefit percentage" and the "base benefit percentage" is reduced under excess plans.
   b. The "maximum offset allowance" is reduced under offset plans.
   c. Maximum excess and offset percentages are established based on 35 years of service.
   d. A special 100% of "final pay" less the employer-provided primary insurance amount under social security (based solely on service with the employer) is established. § 401(a)(5)(D)(i).

3. Defined contribution plans
   a. Permitted disparity may not exceed the lesser of:
      i. 200% of the base contribution percentage, or
      ii. the sum of:
         a. the base contribution percentage, plus
         b. the greater of
            i. 5.7%, or
            ii. the old age insurance rate in effect as of the beginning of the plan year. § 401(1)(2)(A).
   b. Thus, if a plan contributes 3% on compensation up to the integration level in 1989, a contribution of up
to 6% may be made on compensation in excess of the integration level. If an employer contributes 10% on compensation up to the integration level, it may contribute up to 15.7% on the excess.

i. The Secretary of Treasury is authorized to establish rules to prevent discrimination where less than the maximum integration level is used. Conf. Rep. at II-436.

F. Limitations on contributions and benefits

1. Defined benefit plans

   a. No change in the current maximum $90,000 benefit limit.

      i. This limit will be adjusted to reflect post-1986 cost-of-living increases for years beginning after December 31, 1988. § 415(d).


      i. The age at which the maximum benefit may be paid is increased from age 62 to the social security retirement age. § 415(b)(8).

         a. This age is currently 65 and will increase to 67 by 2017. Actuarial adjustments are mandated for benefits payable prior to that time. These required adjustments may be coordinated in a manner consistent with early
retirement reductions under social security.

ii. The maximum dollar limit is increased for retirement after the social security retirement age.

iii. Special rules apply to certain airline pilots, police, fire-fighters, and tax-exempt employers.

c. Ten years of participation are required to obtain a full dollar limit benefit. § 415(b)(5)(A).

2. Defined contribution plans

a. The dollar limit is frozen at the greater of $30,000 or 25% of the defined benefit plan dollar limit. § 415(c)(1).

b. All after-tax employee contributions will be considered part of the "annual addition" in years beginning after December 31, 1986. § 415(c)(2)(B).

3. A participant's "current accrued benefit" in effect as of the close of the last plan year ending before January 1, 1987 (without regard to any post-May 6, 1986 amendments) is generally grandfathered.

G. Cash or deferred arrangements

1. The new limit

a. For an employee's taxable years beginning after December 31, 1986, the excludable limit is $7,000. § 402(g)(1).

i. This limit will be adjusted at the same time future
adjustments are made in the maximum compensation that can be taken into account in a qualified plan and the benefit and annual contribution limitations under § 415 are adjusted.

b. The new rules require coordination with and establish special ordering of deferrals under simplified employee pensions, certain employee pay-all union plans, deferred compensation plans of state or local governments and tax-exempt organizations, and amounts contributed to a tax-sheltered annuity pursuant to a salary-reduction election. § 402(g)(3).

c. All such arrangements in which an individual participates must be aggregated even though different employers may be involved.

2. Excess deferrals

a. Special notice regarding allocation and distribution rules

i. An employee may allocate any excess deferrals for a year among the various arrangements and notify plan administrators on or before the following March 1 of the excess's assigned to such plan. § 402(g)(2)(A).

ii. A plan may (without the employee's consent), but is not required to, distribute the assigned excess (plus earnings) to the employee by April 15 of the following taxable year.
b. Refunded excess deferrals

i. Refunded earnings are includable in the employee's income for the taxable year to which the excess relates.

ii. Such refunds may be made without regard to other provisions of law to the contrary.

iii. Such refunds are not subject to the 10% excise tax on early withdrawal.

c. Retained excess deferrals

i. Ultimate distribution taxed when distributed even though excess constituted after-tax deferral.

ii. Subject to all distribution restrictions and penalties applicable to elective employer contributions.

3. Transition rules

a. $7,000 cap does not apply to elective deferral made in 1987, attributable to services performed during 1986, if, under the terms of the arrangement in effect on August 16, 1986--

i. the employee's election is made before January 1, 1987, and

ii. the employer identifies the amount of such contribution before January 1, 1987.

b. Partners in fiscal year partnerships are deemed to have made elective deferrals ratably during the partnership's fiscal year. This
rule applies only for the fiscal year that includes January 1, 1987.

i. Thus, a partner in a fiscal year partnership ending March 31, 1987, that makes elective deferrals of $30,000 would have made an excess deferral of only $500. That is because three-fourths of the total deferral or $22,500 will be attributed to 1986.

4. Revised nondiscrimination rules

a. Effective for plan years beginning after December 31, 1986, the groups of employees against whom the special nondiscrimination rules applicable to cash or deferred arrangements are tested are changed from the "top one-third" and "lower paid two-thirds" to "highly compensated employees" and "all others."

i. Generally, for this purpose, the new definition of "highly compensated employee" is effective for plan years beginning after December 31, 1986.

b. Effective for plan years beginning after December 31, 1986, the permitted disparity between the average deferrals of the "highly compensated" group and all others is reduced. Under the new rules--

i. the actual deferral percentage for the highly compensated group may not be greater than 125% of the actual deferral percentage for all other employees, or
ii. the actual deferral percentage for the highly compensated group does not exceed the lesser of:

a. the actual deferral percentage for all other employees plus 2, or

b. 200% of the actual deferral percentage for non-highly compensated employees. § 401(k)(3).

iii. The impact of the new limitations is illustrated as follows:(2)

<table>
<thead>
<tr>
<th>ADP for Non-highly Compensated Employees</th>
<th>Maximum ADP for Highly Compensated Employees (Current Law)</th>
<th>Maximum ADP for Highly Compensated Employees (New Rules)</th>
</tr>
</thead>
<tbody>
<tr>
<td>1 percent</td>
<td>2.5 percent</td>
<td>2.0 percent</td>
</tr>
<tr>
<td>2 percent</td>
<td>5.0 percent</td>
<td>4.0 percent</td>
</tr>
<tr>
<td>3 percent</td>
<td>6.0 percent</td>
<td>5.0 percent</td>
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<tr>
<td>4 percent</td>
<td>7.0 percent</td>
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<tr>
<td>5 percent</td>
<td>8.0 percent</td>
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<tr>
<td>6 percent</td>
<td>9.0 percent</td>
<td>8.0 percent</td>
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<tr>
<td>7 percent</td>
<td>10.50 percent</td>
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<td>12.00 percent</td>
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</tr>
<tr>
<td>9 percent</td>
<td>13.50 percent</td>
<td>11.25 percent</td>
</tr>
<tr>
<td>10 percent</td>
<td>15.00 percent</td>
<td>12.50 percent</td>
</tr>
</tbody>
</table>

5. Excess contributions

a. Any excess contributions attributable to highly compensated employees must be distributed to preserve qualified plan status.

b. Generally, if excess contributions are returned within 2½ months after the close of the applicable plan year, the distributions are accorded treatment similar to that accorded contributions exceeding the $7,000 deferral limit.

c. If excess contributions are returned after the 2½-month period has expired but before the end of the next plan year, the distribution will be taxed to the employee when distributed and the employer will be subject to a 10% excise tax on the excess contribution. § 4979.

d. If any excess is not distributed by the end of the plan year following the end of the plan year to which the excess relates, the plan is disqualified.

6. Other changes

a. Special distributions

i. Generally, distributions constituting the entire balance to the credit of an employee under a cash or deferred arrangement, may be made without disqualifying the arrangement after December 31, 1984, for the following reasons:

a. plan termination (unless a successor plan is established)

b. sale of a subsidiary

c. sale of substantially all of the assets used in a trade or business.
§ 401(k)(2)(B)
b. Generally, effective for plan years beginning after December 31, 1988, hardship distributions from cash or deferred arrangements are limited to elective deferrals (exclusive of earnings). § 401(k)(2)(B)(i)(VI).

c. Generally, effective for plan years beginning after December 31, 1988, such plans may not require, as a condition of participation, a period of service in excess of one year. § 401(k)(2)(D).

d. Generally, effective for plan years beginning after December 31, 1988, an employer-provided pension or welfare benefit may not be conditioned, directly or indirectly, on elective deferrals under a cash or deferred arrangement. § 401(k)(4).

e. Generally, effective for plan years beginning after December 31, 1988, elective deferrals under cash or deferred arrangements may not be taken into account for purposes of determining whether any other plan meets the requirements of § 401(a) or 410(b). § 401(k)(4)(C).

f. Governments and tax-exempt employers may not establish plans with cash or deferred arrangements.

i. There are a few special grandfather provisions in this area.

H. Employee contributions and matching employer contributions

1. Effective for plan years beginning after December 31, 1986, the special non-discrimination tests applicable to cash or deferred arrangements are extended to "employee contributions" and "matching employer contributions." § 401(m).
a. Employee contributions include both voluntary and mandatory contributions.

b. Matching contributions include any employer contribution made to a plan on account of either an employee contribution to such plan or an employee's elective deferral under a qualified cash or deferred arrangement. § 401(m)(4)(A).

2. In making these tests, an employer may elect to take into account certain "elective contributions" made pursuant to employee cash or deferred elections and "qualified non-elective contributions." This latter group includes what have been previously referred to as safe-harbor contributions.

3. Such amounts are not subject to hardship withdrawal.

IV. Distributions

A. Uniform commencement

1. Generally, effective for taxable years beginning after December 31, 1986, uniform distribution rules are extended to all qualified plans, tax-sheltered annuities, and individual retirement accounts.

   a. Distributions must commence no later than April 1 of the calendar year following the year in which the participant attains age 70½ without regard to the actual date of retirement.

   b. All distributions must satisfy the requirements of § 401(a)(9) and the incidental benefits rule.
2. Exceptions
   
a. Distributions made pursuant to valid TEFRA section 242(b)(2) elections.

   b. Employees who are not 5% owners and who attain age 70½ on or before January 1, 1988, may defer commencement until retirement.

3. Sanctions
   
a. 50% excise tax assessed against the participant on the excess (if any) of (i) the minimum required distribution, over (ii) the amount actually distributed.

B. Excise taxes on early distributions

1. A 10% excise tax applies to the portion of post-1986 early distributions from qualified plans, tax-sheltered annuities, and IRAs includable in gross income. § 72(t).

2. Exempt distributions
   
a. Post-age 59½ distributions.

   b. Distributions after death.

   c. Distributions made on account of disability.

   d. Distributions made from a retirement plan or an IRA in the form of substantially equal periodic payments over the life (or the joint lives of the employee and beneficiary).

   e. Distributions from a retirement or annuity plan (other than an IRA) if distributions are made after the employee attains age 55 and separates from service on account of early retirement under the plan.
i. If such a distribution commences before age 59½ and is later modified for reasons other than death or disability before the individual attains 59½ or prior to the end of the 5-year period beginning on the date the distribution commenced, an excise tax equal to 5% of all pre-age 59½ payments applies.

f. Distributions from a retirement plan (but not an IRA) of medical expenses that are deductible under § 213.

g. Certain distributions from an eligible ESOP, including certain distributions of dividends paid on employer securities held thereunder.

h. Distributions to alternate payees pursuant to QDROs.


j. Distributions made pursuant to valid TEFRA § 242(b)(2) elections.

k. Distributions to folks who separated from service prior to March 1, 1986, and whose benefits were in pay status on that date to the extent the distribution is made pursuant to the written election.

C. Excise tax on excess distributions

1. Generally, for taxable years beginning after 1986, a new 15% excise applies to annual distributions to an individual from all qualified plans, tax-sheltered annuities, and IRAs in which the individual participates.
2. An "excess distribution" is the amount by which such annual distribution exceeds the greater of $150,000 or $112,500 (adjusted to reflect post-1986 cost-of-living increases measured by the CPI). § 4981(c)(1).

a. Excess distributions do not include for this purpose:

i. A retirement distribution made with respect to an individual after the individual's death.

ii. Retirement distributions made with respect to an individual payable to another person pursuant to a QDRO.

iii. Distributions of after-tax contributions.

iv. Retirement distributions rolled over to an IRA.

b. Net unrealized appreciation in employer securities is taken into account in calculating excess distributions.

3. Distributions eligible for 5-year (and presumably 10-year) income averaging as lump-sum distributions are subject to special limits. Generally, this limit is 5 times the generally applicable limit. Thus, an individual could receive a lump-sum of $562,500 (5 x $112,500) plus other distributions of $112,500 or $675,000 in a taxable year without being subject to the tax on excess retirement distributions. § 4981(c)(4).

a. It is unclear whether the special $150,000 transition limit applies to lump-sum distributions. If it does an individual could receive as much
as $900,000 in one year without being subject to this special tax.

4. Special estate tax

a. Under the new rules, a special 15% estate tax applies to the decedent's "excess retirement accumulation." This is the value of the decedent's interest in all qualified retirement plans, tax-sheltered annuities, and IRAs over the present value of a life annuity equal to the annual benefit ceiling at the time of the individual's death.

i. It is unclear whether the special $150,000 transition rule applies to this calculation.

b. This tax may not be offset by estate tax credits, including the decedent's "unified credit." § 4981(d)(2).

5. Transitional rules

a. To the extent an individual's August 1, 1986 accrued benefit exceeds $562,500, it is exempt from the special excise and estate taxes.

b. Taxpayers subject to the transitional rules may elect to calculate their excess distributions or accumulations under a "pro rata rule" or an "alternative pro rata rule" to be formulated by the Secretary of Treasury.

i. Application of the "pro rata rule" must be elected on a tax return filed before the due date of a tax return for a taxable year beginning before January 1, 1989.
D. Basis recovery rules

1. Generally, effective for distributions made in taxable years beginning after December 31, 1986, uniform basis recovery rules apply to both pre- and post-annuity starting date distributions.

2. In the case of pre-annuity starting date distributions and non-annuity post-annuity starting date distributions, under the so-called "pro rata" rule, a participant excludes from income the portion of the distribution equal to the ratio the employee's after-tax contributions bears to the total value of the participant's vested accrued benefit or account balance as of the date of distribution. § 72(e)(8)(B).

   a. Amounts distributed from a plan which on May 5, 1986 permitted withdrawals of employee contributions before separation from service, are grandfathered to the extent distributions do not exceed the total amount of after tax contributions held by the plan on December 31, 1986. § 72(e)(8)(D).

3. The three-year basis recovery rule is repealed with respect to post-annuity starting date distributions commencing after July 1, 1986, and the current exclusion ratio rules are extended to all distributions made in the form of an annuity.

   a. In the case of distributions with post-1986 annuity starting dates, the exclusion is limited to actual basis. § 72(b)(2).

   b. Further, in the case of annuities with post-1986 annuity starting dates, any unrecovered basis will be allowed as a deduction to an
annuitant in his final taxable year. § 72(b)(3).

4. The new basis recovery rules are also extended to IRAs for taxable years beginning after 1986. §§ 408(d)(1) and (2).

E. Lump-sum distributions

1. Long-term capital gains

a. Generally, for most post-1986 distributions, the capital gains provisions applicable to lump-sum distributions are phased out in accordance with the following schedule:

<table>
<thead>
<tr>
<th>Year of Distribution</th>
<th>Capital Gain Phase-Out Percentage</th>
</tr>
</thead>
<tbody>
<tr>
<td>1987</td>
<td>0%</td>
</tr>
<tr>
<td>1988</td>
<td>5%</td>
</tr>
<tr>
<td>1989</td>
<td>25%</td>
</tr>
<tr>
<td>1990</td>
<td>50%</td>
</tr>
<tr>
<td>1991</td>
<td>75%</td>
</tr>
<tr>
<td>1992</td>
<td>100%</td>
</tr>
</tbody>
</table>


2. Special averaging rules

a. Generally, for post-1986 distributions, the availability of the 10-year averaging rules are limited
and replaced with a new 5-year averaging convention.

i. Except for certain grandfathered individuals, only individuals who have attained age 59½ may elect to take advantage of one lump-sum distribution. § 402(e)(4)(B).

ii. Individuals who had attained age 50 by January 1, 1986, may make one election at any age to use either the new 5-year averaging rule or the current 10-year forward averaging rule at current rates on any single lump-sum distribution. Conf. Rep. at II-461.

V. Qualified Plan Loans

A. General. A number of new rules apply with respect to loans that are not treated as distributions under the general rules.

1. Reduced limits. For post-1986 loans, the current $50,000 limit is reduced by the excess of (i) the participant's highest outstanding loan balance during the prior 12 months over (ii) the outstanding loan balance on the date of the new loan. § 72(p)(2)(A)(i).

2. Amortization requirements. Loans must be amortized in level payments made not less frequently than annually over the term of the loan. § 72(p)(2)(C).

3. Exception to 5-year rule. Only loans made in connection with the purchase of a principal residence of the participant qualify for the exception to the 5-year repayment rule. § 72(p)(2)(B)(ii).
4. Interest expense

a. The new rules regarding the deductibility of consumer interest apply to plan loans. § 72(p)(3)(A).

i. These rules generally "phase out" the consumer interest deduction from 1987-1990.

ii. There is no exception for pre-1987 plan loans.

b. Post-1986 loans not otherwise affected by the new consumer interest rules will be denied if paid--

i. on a loan secured by elective deferrals, or

ii. by a key employee.

a. A key employee is generally any person who during the current plan year is or was during the four preceding plan years (i) an officer with compensation of 150% of the defined contribution annual addition limitation for such year (currently $30,000); (ii) one of the 10 employees having annual compensation in excess of the applicable annual addition limitation and owning the largest interests in the employer; (iii) a 5% owner; or (iv) a 1% owner who earns more than $150,000 from the employer.

c. No basis adjustment will be provided for the amount of any nondeductible

d. Loans made before year end that generate qualified residence interest may preserve for up to five years interest which will otherwise become nondeductible.

VI. ESOPs

A. General

1. Asset reversion tax exception

   a. In addition to the exception to the asset reversion tax, certain transferred amounts transferred from defined benefit plans are not includable in the employer's gross income.

   b. The waiver applies to (i) amounts transferred after March 31, 1985, and before January 1, 1989, or (ii) after December 31, 1988, if the termination occurred after March 31, 1985, and before January 1, 1989. § 4980(c)(3).

2. Dividends

   a. Dividends paid on ESOP stock that are deductible under § 404(k) are exempt from the 10% additional tax on early distributions.

   b. The § 404(k) deduction for dividends paid on ESOP stock is expanded to apply to dividends that are used to make payments on an exempt loan. § 404(k)(2)(C).

   i. The Conference Report clarifies that the deductibility of dividends applies to dividends on unallocated shares held in a
pledged suspense account as well as to dividends on allocated shares. Conf. Rep. at p. II-852.

ii. Such dividends are to be treated as income and thus do not constitute "annual additions" under § 415. Conf. Rep. at p. II-556.

3. Distributions
   a. Certain pre-1990 distributions are exempted from the 10% excise tax on early distributions.
   b. Several revisions designed to accelerate distribution commencement dates are made.

4. Put options
   a. The Act modifies the permissible periods over which an employer may pay the put option price.
   b. A reasonable rate of interest and adequate security are now required for deferred payouts of the option price.
   c. The rules are extended to all stock bonus plans.

5. The interest exclusion
   a. Mutual funds are added to the list of lenders eligible for the interest exclusion.
   b. The exclusion is also available with respect to certain loans to corporations.
   c. The new law confirms that the interest exclusion applies to
post-May 23, 1984 refinancing loans
used to acquire employer securities.

d. The new law also confirms the appli-
cation of the interest exclusion to
loans used to refinance a loan which
met the requirements of § 133(b)(1)
when made and that was used to
acquire securities after July 18,

e. The new law provides rules by which
a loan to a corporation may qualify
as a securities acquisition loan.

f. The new law clarifies that an
employer may make a loan to an ESOP
and then refinance it with an
eligible lender. The lender would
then be entitled to the interest
exclusion.

g. The new law provides that exempt
interest under § 133 is not a
financial institution preference.
§ 291(e)(1)(iv).

h. Section 133 was amended to provide
for adjustments in the applicable
Federal rate attributable to the
partial interest exclusion.

i. Section 7872 (below-market interest
rate loans) is amended to provide
that it does not apply to an exempt
loan between an employer and an ESOP
to the extent the interest rate is
equal to the interest rate paid on a
related securities acquisition loan
to such employer.

6. The ESOP identity crises

a. The Senate Finance Committee's
policy statement that was intended
to diffuse some of the ERISA Title I
concerns by stating that ESOPs were
primarily a unique kind of financing device was deleted in Conference. Thus, fiduciary concerns remain.

7. Additional § 401(k) credit
   a. The additional $2,500 § 401(k) contribution limit for ESOP contributions was not adopted.

8. Diversification requirements
   a. An employee who has attained age 55 and been an ESOP participant for 10 years (a "qualified participant") is to be given the right to invest 25% (50% in the final year) of his account balance in something other than employer securities.
      i. The "election period" is the 5-plan-year period commencing with the plan year following the year in which the participant becomes a "qualified participant."
      ii. The new requirement may be satisfied by either cashing out the elected portion or providing three investment options.

9. Independent appraiser
   a. An independent appraiser is now required for non-publicly traded securities. Generally, the charitable contribution rules must be followed to determine independence.

10. New estate tax deduction
   a. One-half of the "qualified proceeds" of a "qualified sale" of employer securities to an ESOP before
December 31, 1991 may be deducted from the value of the decedent's gross estate. § 2057.

11. New unrealized appreciation
   a. Section 402 is amended to preserve net unrealized appreciation treatment in situations where the plan trustee has exchanged or sold and repurchased new employer securities. §§ 402(a) and (e)(4)(J).

12. Section 1042 transactions
   a. New § 409(n) clarifies the rules regarding the allocation of shares acquired in a § 1042 transaction. The Conference Report suggests that a compensating allocation may be made outside the qualified plan in a nonqualified plan.

VII. Miscellaneous

A. Tax-sheltered annuities
   1. A special dollar cap equal to the greater of $9,500 or the indexed $7,000.
   2. An extra allowance is available in limited circumstances.

B. Simplified employee pensions
   1. May offer elective pre-tax deferrals under certain circumstances. Generally, 50% of employees must participate.

C. Deductions
   1. For taxable years beginning in 1987, several changes are made.
      a. The unused limit carryforward for profit sharing plans is repealed.
b. The 25% limit on aggregate deductions is extended to any combination of defined contribution and defined benefit plans.

c. A new 10% excise tax is imposed on nondeductible contributions.

D. Reversion tax

1. Reversions received after 1985 in connection with a post-1985 termination of a qualified plan are generally subject to a 10% excise tax on the amount of the reversion.

a. The tax does not apply to plans maintained by tax-exempt organizations except to the extent the organization has received a tax benefit from plan contributions or has received unrelated trade or business income.

b. The tax does not apply to a reversion transferred to an ESOP if used within 90 days to purchase qualifying employer securities or to repay a prior ESOP loan, so long as such purchased securities are allocated in seven years and at least 50% of the active participants in the ESOP were participants in the terminated plan.

c. The reversion tax applies to amounts distributed to employers from participating annuities.

d. The reversion tax does not apply to amounts that could have been distributed without violating the qualification requirements.

E. Profitless profit sharing plans. Current or accumulated earnings or profits is no longer a
pre-condition of maintaining a profit sharing plan.

F. Overstatement of pension liabilities. Overstatements of pension liabilities occurring after the enactment of the TRA 1986 that cause understatements of income tax liabilities will trigger an excise tax on the employer based on the size of the understatement. Understatements of 150% or more, 200% or more, or more than 250% will trigger an excise tax on the employer equal to 10%, 20% or 30%, respectively, of the underpayment.

G. Cashouts. For plan years beginning after 1987, an interest rate no greater than the applicable PBGC rate may be used to cash out a participant if the present value of the benefit does not exceed $25,000. For benefits whose present values exceed $25,000, a rate no greater than 1.2 times the applicable PBGC rate may be used.

H. Leased employees. Section 414(n) is amended, effective for years beginning after 1983, to require a 10% rather than a 7.5% contribution to a safe-harbor plan.

1. The plan must cover all employees except those that work exclusively for the leasing organization or earn less than $1,000 per year.

2. The exception does not apply in any case where more than 20% of the recipients' non-highly compensated work force constitutes leased employees.

I. Top-heavy plans. For plan years beginning after 1986, non-key employee benefits must be accrued under either the method used for all plans of the employer or the slowest rate permitted under § 410(b).

1. The provision precludes minimizing the long-term value of the minimum accrual provisions of § 416.
J. Money purchase plan forfeitures. For plan years beginning after 1986, forfeitures may be reallocated.

K. Effective dates
   2. Collective-bargaining agreements.

L. Compliance
   1. Deferral of restatements.
   2. Impact of Title I of ERISA on participants' rights.

VIII. Welfare Benefit Plans

A. General. TRA 1986 establishes significant new rules applicable to most employee welfare benefit plans.
   1. Depending on the timing of the promulgation of regulations, the new rules will generally be effective for plan years beginning after December 31, 1987 or December 31, 1988.
      2. The new rules generally extend various qualified plan rules to welfare benefits and establish substantial nondiscrimination in coverage and benefits rules.
      3. Generally, the sanction for failure to comply with the new rules is the taxation of benefits to highly compensated employees.

B. Cafeteria plans
   1. Each benefit under a cafeteria plan is subject to the new rules, but the plan remains subject to the eligibility tests of § 125(b).
2. Cafeteria plans may now permit elections solely between different qualified benefits.

3. Amounts contributed to a cafeteria plan pursuant to a salary-reduction agreement in plan years beginning after 1983 are not subject to FICA and FUTA taxes.

C. Health insurance for self-employed

1. For taxable years beginning after December 31, 1986 and before January 1, 1990, a self-employed individual may deduct 25% of the amounts paid for health insurance for himself, his spouse, and dependents.

D. COBRA technical corrections

1. Various technical corrections were made with respect to the extended medical coverage requirements passed in the Consolidated Omnibus Budget Reconciliation Act.

E. Extended medical coverage in certain bankruptcies

1. Commencing on or after July 1, 1986, the Omnibus Budget Reconciliation Act of 1986 ("H.R. 5300") entitles retirees and dependents who lose their employer-based health insurance because their employer files for Chapter 11 bankruptcy, to remain in the plan by paying a premium. Coverage is to be available until the retiree's death. A surviving spouse or dependent children may elect to remain in the plan for up to three additional years.

IX. Nonqualified Deferred Compensation

A. Basic changes in the tax structure

1. Individual versus corporate rates.
2. Repeal of the capital gains deduction.

3. Changes in the rules regarding interest deductions.
   a. Personal
      i. Consumer
      ii. Residential
   b. Investment
   c. Corporate-owned life insurance

B. The new focuses
   1. Cash
      a. Equity forms of compensation designed to produce capital gains with no employer deduction will be less attractive.

2. Timing
   a. Accelerate capital gains.
   b. Consider taking lump-sum distributions from qualified plans.
   c. Consider loans and withdrawals from qualified plans.
   d. Defer earned income.

C. Incentive stock options
   1. Sequential exercise rule repealed with respect to post-1986 grants.
   2. $100,000 limit applies to annual exercise, not grant.
   3. Impact of loss of capital gains deduction and minimum tax.
4. Relative attractiveness of nonqualified options.

D. Golden parachutes
   1. Small business exception.
   2. Shareholder approval exception.
   3. Reasonable compensation for future services.
   4. Distributions from qualified plans.

E. Excess benefit and top-hat plans
   1. Impact of § 415 changes and $200,000 compensation cap under § 401(a)(17).
   2. Exposure under excess benefit plans.

F. Tax Exempts
   1. Application of § 457.

X. Post-Normal Retirement Age Accruals

A. General. The Omnibus Budget Reconciliation Act of 1986 ("H.R. 5300") mandates benefit accruals and contributions with respect to plan participation after normal retirement age.

   1. Plans may impose a limitation on the amount of benefits provided or the years of service taken into account in computing benefits.

   2. With respect to plan years beginning on or after January 1, 1988, the new law eliminates the provision allowing employers to exclude from plan coverage individuals hired within five years of normal retirement age.
XI. Mandatory Retirement

A. General. H.R. 4154, amending the Age Discrimination in Employment Act, was signed into law by the President on November 1, 1986. The bill covers employers with 20 or more employees and removes the mandatory retirement age.