The Impact of TEFRA on Employee Benefits

Louis A. Mezzullo
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I. LIMITATIONS ON CONTRIBUTIONS

TEFRA amends I.R.C. §§ 415 and 404 to limit the benefits that may be provided to participants in qualified pension, profit-sharing, and stock bonus plans. The maximum dollar limitations on the annual additions and annual benefits that can be made on behalf of or provided to a participant have been reduced significantly. Before TEFRA, the maximum annual addition on behalf of a participant was the lesser of $25,000 or 25% of the participant's compensation. The $25,000 limit, established in 1974, was subject to cost-of-living adjustments. By 1982, the dollar limit had been increased to $45,475. Annual additions consist of employer contributions, forfeitures, and certain employee contributions. TEFRA reduces the dollar limit to $30,000. This dollar limit will remain constant until years beginning after December 31, 1985, when this amount will again be adjusted, based on the social security benefit index formula then in effect. The reduced dollar limitation is effective for plans in existence on July 1, 1982, for years beginning after December 31, 1982, and for plans not in existence on July 1, 1982, for years ending after July 1, 1982.

Before TEFRA, the maximum annual benefit that was permitted from employer contributions to a defined benefit plan was the lesser of 100% of the participant's annual compensation over his highest three consecutive years or $75,000. The $75,000 limit established in 1974 was subject to cost-of-living adjustments. By 1982, the dollar limit had been increased to $136,425. The annual benefit meant a straight life annuity without ancillary benefits. Reductions in the maximum annual benefit were required for ancillary benefits, such as a guaranteed payment or survivor annuity, except for a joint and survivor annuity, benefiting the surviving spouse. Reductions in the annual benefit were also required if the normal retirement age was lower than age 55. The maximum annual benefit was also reduced if the participant retired with less than ten years of service.

TEFRA reduces the dollar limitation to $90,000. This dollar limit will remain constant until years beginning after December 31, 1985, when this amount will again be adjusted, based on the social security benefit index formula. The reduced dollar limitation is effective for plans in existence on July 1, 1982, for years beginning after December 31, 1982, and for plans not in existence on July 1, 1982, for years ending after July 1, 1982. The dollar limitation will be reduced actuarially if the participant retires before age 62, except that a floor of $75,000 is reached at age 55. If retirement occurs before age 55, the dollar limitation is reduced to the actuarial equivalent of $75,000 at age 55. The interest rate used for actuarial reductions is the greater
of five percent or the rate specified in the plan. The $90,000 limit is increased for retirement after age 65 to the actuarial equivalent of $90,000 at age 65, but using an interest rate equal to the lesser of 5% or the rate specified in the plan. Future cost of living increases cannot be assumed or anticipated in arriving at the actuarial equivalents.

Before TEFRA, if a participant was covered by both a defined benefit plan and a defined contribution plan maintained by the same employer (or another member of a controlled group of employers), the participant could be provided benefits aggregating to 1.4 times the maximum benefit allowable under each type of plan. For example, if John Smith participated in a money purchase pension plan (a defined contribution plan) that provided for an annual contribution of 25% of compensation, Smith could also participate in a defined benefit plan maintained by the same employer that provided for an annual benefit of 40% of his average compensation during his highest three consecutive years. On the other hand, if Smith participated in a defined benefit plan that provided for an annual benefit of 100% of his average compensation during his highest three consecutive years, he could also participate in a money purchase pension plan maintained by the same employer that provided for an annual contribution of 10% of compensation. The 1.4 rule was more complicated with respect to situations where the participant had participated in one or more defined contribution plans, and then began participating in a defined benefit plan seeking to obtain the maximum annual benefit.

TEFRA reduces the 1.4 limit to the lesser of (x) 1.25 as applied to the dollar limit or (y) 1.4 as applied to the percentage limit. This result is achieved by redefining the defined benefit plan fraction and the defined contribution plan fraction. The numerator of the defined benefit plan fraction is the projected annual benefit determined as of the close of the year. The denominator of the fraction is the lesser of (x) the maximum dollar limit for such year (for example, $90,000 in 1983) times 1.25 or (y) the percentage of compensation limit for such year times 1.4.

The numerator of the defined contribution plan fraction is the total of the annual additions to the participant’s account through the end of the year. The denominator of the fraction is the sum of the following amounts determined for each year of service: the lesser of (x) the maximum dollar limit for such year (for example, $30,000 for calendar year 1983, $45,475 for calendar year 1982, and $41,500 for calendar year 1981) times 1.25 or (y) the amount determined under the percentage of compensation limit for such year (25% of compensation) times 1.4. The total of the two fractions cannot exceed one (1).

If a participant’s current accrued benefit exceeds $90,000 (because the maximum benefit under prior law has been provided under the plan) then the denominator of the defined benefit plan fraction is the lesser of (x) the dollar amount of the current accrued benefit or (y) the
percentage of compensation limit multiplied by 1.4. This transition rule is explained in more detail below.

An alternative method of determining the denominator of the defined contribution plan fraction permits the plan administrator to elect to increase the denominator (and therefore reduce the defined contribution fraction) by multiplying the denominator determined under the rule in effect before TEFRA (in other words, the sum of the lesser of (x) the dollar limitation for each year of service or (y) the percentage limitation for each year of service) by a fraction. The numerator of the fraction is the lesser of (x) $51,875 or (y) 1.4 multiplied by 25% of the compensation of the participant for the year ending in 1981. The denominator of the fraction is the lesser of (x) $41,500 or (y) 25% of the compensation of the participant for the year ending in 1981.

Another transition rule authorizes the Treasury to issue regulations permitting a reduction in the defined contribution plan fraction by reducing the numerator so that the total of the defined benefit plan fraction and the defined contribution plan fraction does not exceed one in situations where the Section 415 limitations were met under the old law, but the fraction as computed under the new law exceeds one in plan years beginning in 1982.

The transition rule discussed above in connection with the defined benefit plan fraction avoids the reduction of a participant's previously accrued benefit in a defined benefit plan by making the dollar limit equal to the participant's current accrued benefit, if he participated before January 1, 1983, in a plan that was in existence on July 1, 1982, and if the plan satisfied the Section 415 limitations for all plan years. A participant's current accrued benefit is his accrued benefit at the close of the last year beginning before January 1, 1983. In determining the current accrued benefit, no change in the plan or cost-of-living adjustments after July 1, 1982, are to be taken into account. No additional accrual will be allowed until the new dollar limit exceeds the participant's current accrued benefit as the result of cost-of-living adjustments authorized after 1985.

No deductions will be allowed for years beginning after December 31, 1982, for contributions to a plan in excess of the new Section 415 limits. Anticipated cost-of-living increases may not be taken into account in determining contributions to defined benefit plans, which codifies the current position of the Internal Revenue Service.

A plan in existence on July 1, 1982, will not fail to be qualified for any year beginning before January 1, 1984, merely because the plan provides for benefits or contributions that exceed the new limit. Plan amendments conforming to the new limits will be required no later than the last day of the first plan year beginning after December 31, 1983, effective as of the first day of such plan year. It is conceivable that a nondeductible contribution may be required under I.R.C. § 412 (the minimum funding provisions) for a year beginning after December 31, 1982 if a pension plan is not amended to reduce the promised bene-
fit. The participant may also have a contractual right under state law to the increased benefit until the plan is amended. IRS Notice 82-19 provides a simplified amendment that may be adopted before the end of the 1982 limitation year that will prevent the accrual of a benefit in excess of the new limitations.

In the case of a plan maintained on the date of enactment (September 3, 1982) under one or more collective bargaining agreements, the new limits do not apply until the year beginning before the earlier of: (i) the date on which the last of the collective bargaining agreements relating to the plan terminates (determined without regard to any extension agreed to after September 3, 1982), or (ii) January 1, 1986.

II. LIMITATIONS ON PLAN LOANS

Loans from a tax qualified plan, government plan, or a tax-sheltered annuity arrangement (including a custodial account investing in stock of a regulated investment company) made after August 13, 1982, will be treated as a distribution to the participant to the extent that when added to the outstanding balance of all other loans from the plan to the participant, the total exceeds the greater of: (i) $10,000 or (ii) the lesser of (x) $50,000 or (y) one-half of the present value of the employee's nonforfeitable (vested) accrued benefit under the plan.

Such loans must provide for repayment within five years. Any amounts not repaid within five years will be treated as a distribution at the end of the five year period. The five year repayment rule does not apply to any loan used to acquire, construct, reconstruct, or substantially rehabilitate a dwelling that is used or is to be used within a reasonable time as a principal residence of the participant or a member of his or her family.

The plan's tax qualification is not adversely affected because loans are treated as distributions under the new rules at a time when distributions are not otherwise permitted under the plan. (Senate Committee Explanation.) Repayments of loans will be considered nondeductible employee contributions, but will not be treated as annual additions for purposes of the Section 415 limitations; nor will the repayments be subject to the antidiscrimination rules.

The following transactions are treated as loans: (i) a direct or indirect loan by a participant or beneficiary from the plan, or (ii) an assignment or pledge (or an agreement to assign or pledge) any portion of a participant's interest in the plan. Plans of separate employers that are generally treated as a single employer under the rules of I.R.C. § 414 dealing with controlled groups of employers, commonly controlled trades or businesses and affiliated service groups are treated as one plan.

A qualified refunding loan will not be treated as a distribution to the extent it is repaid before August 14, 1983. A qualified refunding loan means any loan made after August 13, 1982, and before August
14, 1983, to the extent it is used to make a required principal payment. A required principal payment means any principal repayment on a loan under a plan which was outstanding on August 13, 1982, if such repayment is required to be made after August 13, 1982, and before August 14, 1983.

Present rules concerning loans from qualified plans continue to apply. Loans must be made available to all participants on a reasonably equivalent basis. Loans must not be made available to highly compensated employees, officers, or shareholders in an amount greater than the amount made available to other employees. The loan must be made in accordance with specific provisions regarding such loans set forth in the plan. The loan must bear a reasonable rate of interest and must be adequately secured. However, loans are still not permitted to owner-employees (sole proprietors and partners owning more than a ten percent interest in a partnership) and shareholder-employees (more than five percent shareholders in a Subchapter S Corporation). I.R.C. § 4975(d) and § 408(d) of the Employee Retirement Income Security Act of 1974 (ERISA).

III. PARITY RULES FOR CORPORATE AND KEOGH PLANS

Limitations on contributions on behalf of self-employed individuals will be the same as for corporate plans. The 15% or $15,000 limitation on contributions to defined contribution plans on behalf of self-employed individuals and shareholder-employees in Subchapter S corporations is eliminated. The limitation on benefit accruals under a defined benefit plan on behalf of self-employed individuals and shareholder-employees is eliminated. (I.R.C. § 401 (j), which contains special rules for such plans, has been repealed.) The definition of earned income of a self-employed individual has been revised to correspond to the compensation of a common law employee. No change is made to the rules (x) prohibiting deductions for contributions to a Keogh plan on behalf of a self-employed individual to the extent used to purchase incidental life, health, or accidental insurance and (y) denying any basis for premiums paid for life insurance. The maximum dollar limitation for employer contributions to simplified employee pension plans is also increased to $30,000, in addition to the $2,000 limit on employee contributions.

The following special qualification requirements for plans benefiting owner-employees (sole proprietors and partners owning a more than ten percent interest) have been repealed: (i) all employees with three years of service must be covered under the plan, (ii) no contributions can be made on behalf of an owner-employee in excess of the deduction limit, (iii) the six percent excise tax on excess contributions on behalf of owner-employees, (iv) limits on non-deductible voluntary employee contributions by an owner-employee, (v) prohibition on mandatory employee contributions, (vi) an owner-employee must consent in writing to participate in the plan, (vii) the trustee of the plan
must be a bank or other approved financial institution, (viii) the five-year prohibition on participation if an owner-employee receives a premature distribution from the plan (before age 59½ or disability), and (ix) a profit-sharing plan must contain a formula for determining contributions on behalf of non-owner employees.

The $5,000 income tax exclusion for death benefits provided under I.R.C. § 101(b) is available to self-employed individuals dying after December 31, 1983. The $200,000 limit on compensation ($100,000 in the case of a defined benefit plan) that can be taken into account in determining contributions or benefit accruals has been eliminated. Keogh plans are permitted to integrate with social security on the same basis as corporate plans. Under prior law, if more than one-third of the contributions went to owner-employees, integration was not permitted. The 6% tax on premature distributions before age 59½, disability, or death is eliminated. These provisions are effective for years beginning after 1983.

Several provisions that formerly applied only to Keogh Plans now apply to all plans. Benefits payable from a qualified plan after December 31, 1983, must commence no later than the later of: (i) the taxable year in which the participant attains age 70½, or (ii) the year in which the participant retires (except a key employee participating in a top-heavy plan). After 1983, if a participant dies before his or her entire interest is distributed, the balance must be distributed to a beneficiary within five years, unless the distribution has already begun to the participant and the payment period under the form of distribution did not exceed the joint life expectancy of the participant and his or her spouse. A transition rule permits distributions under a designation made before January 1, 1984, providing for a method that does not qualify under TEFRA but which qualified under the law in effect before TEFRA.

IV. TOP-HEAVY PLANS

Effective for years beginning after 1983, the following new qualification requirements will apply to plans that primarily benefit key employees: (i) accelerated vesting, (ii) minimum benefits, (iii) limits on compensation that can be used for determining benefits or contributions, and (iv) reduction in the 1.25 limit applicable to combination plans.

The definition of a top-heavy plan depends upon whether the plan is required to be aggregated with other plans. A defined benefit plan which is not required to be aggregated is top-heavy if the present value of the cumulative accrued benefits for all key employees under the plan exceeds 60% of the present value of the cumulative accrued benefits for all employees under the plan. A defined contribution plan which is not required to be aggregated is top-heavy if the aggregate of the accounts of key employees under the plan exceeds 60% of the aggregate of the accounts of all employees under the plan. Simplified employee pension plans are treated as defined contribution plans, and
the employer may elect to use the aggregate employer contributions rather than the aggregate of the accounts of employees in determining whether a simplified employee pension plan is top-heavy.

All plans of a top-heavy group are treated as top-heavy plans. A top-heavy group is any group of plans required to be aggregated if the sum of the present value of accrued benefits and the aggregate of accounts for all key employees in such group exceeds 60% of a similar sum determined for all employees of such group. Plans required to be aggregated are plans in which a key employee of an employer participates and each other plan of the same employer which enables the plan or plans benefiting such key employees to meet the anti-discrimination and coverage rules of I.R.C. § 401(a)(4) or 410. An employer may include any other plan in the group even though such plan is not required in order to qualify under I.R.C. § 401(a)(4) or 410, as long as the group continues to meet the requirements of those sections after the plan or plans are added at the election of the employer. If a group is not top-heavy, any plan that is part of the group will not be treated as top-heavy even though the plan would be top-heavy if tested alone.

The present value of the accrued benefit of an employee or the amount in the account of an employee includes distributions made to the employee during the five-year period ending on the determination date. For purposes of determining the present value of accumulated accrued benefits under a defined benefit plan and the sum of the account balances under a defined contribution plan, benefits derived from both employer contributions and employee contributions generally are taken into account. However, accumulated deductible employee contributions are to be disregarded. Rollover contributions after December 31, 1983, are not taken into account unless required by regulations to be issued by the Treasury. Apparently rollover contributions before January 1, 1984, will be included in an employee's accrued benefit or account balance. The accrued benefits and accounts of employees who were key employees in prior years, but who are no longer treated as key employees, are disregarded in determining whether a plan is a top heavy plan. The determination of whether a plan is top-heavy is made on the last day of the preceding plan year, or in the case of a new plan, the last day of the first plan year. Regulations will be issued that will permit years other than plan years to be used for purposes of determining whether a plan is top-heavy.

A key employee is a participant in an employer plan who, at any time during the plan year or four preceding plan years, is: (i) an officer of the employer; (ii) one of the ten employees owning the largest interest in the employer (using I.R.C. § 318 attribution rules); (iii) a five percent owner of the employer; or (iv) a one percent owner of the employer having an annual compensation from the employer in excess of $150,000.

No more than 50 employees, or, if lesser, the greater of 3 persons or
10% of the employees shall be treated as officers. If there are more officers than are required to be counted, those with the highest compensation will be treated as key employees. Except in the case of a one percent owner or where there are more officers than required, compensation is not a factor in determining who is a key employee. Note, however, highly compensated employees are members of the prohibited group under I.R.C. § 401(a)(4).

If an employer is a corporation, a five percent owner is any person owning more than five percent of the outstanding stock of the corporation or stock possessing more than five percent of the total combined voting power of all stock of the corporation. If not a corporation, a five percent owner is any person who owns more than five percent of the capital or profits interest of the employer. The rules for a one-percent owner are the same as for a five-percent owner. Constructive ownership rules under I.R.C. § 318 will apply in determining stock ownership. In applying I.R.C. § 318(a)(2)(C), dealing with attribution from corporations, 5% is substituted for 50%. In the case of non-corporate employers, ownership shall be determined under regulations to be issued using the I.R.C. § 318 attribution rules as a guide with the modification mentioned above with respect to attribution from corporations. The aggregation rules of subsections (a), (b) and (m) of I.R.C. § 414 do not apply in determining ownership in the employer.

A non-key employee is any employee who is not a key employee. The terms employee and key employee include their beneficiaries. Self-employed individuals are treated as employees, and the earned income of the self-employed individual is treated as compensation.

A top-heavy plan must provide one of the following two vesting methods: (i) one hundred percent vesting after at least three years of service, or (ii) six-year vesting under the following schedule:

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<th>Years of Service</th>
<th>Vesting Percentage</th>
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<td>5</td>
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<td>100%</td>
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The plan must provide a minimum annual retirement benefit to all non-key employees equal to (i) the lesser of (x) 2% times the participant's years of service or (y) 20%, times (ii) the participant's average compensation for a period of up to five consecutive years during which the participant's aggregate compensation from the employer was the highest. Years of service do not include years when the plan was not top-heavy or years completed before January 1, 1984. Annual retirement benefit means a benefit payable annually in the form of a single life annuity with no ancillary benefits, beginning at the normal retirement age under the plan. The up-to-five consecutive years of service
period does not include years before January 1, 1984, or years after the close of the last year in which the plan was a top-heavy plan.

Employer contributions on behalf of non-key employees must equal the lesser of: (i) three percent of the employee's compensation, or (ii) the percentage at which contributions are made or required to be made on behalf of any key employee for whom the percentage is the highest, using only the first $200,000 of such key employee's compensation.

For purposes of determining the maximum percentage, all defined contribution plans required to be aggregated in a top-heavy group are treated as one plan. The three percent minimum applies, regardless of the maximum contribution percentage with respect to key employees, to a defined contribution plan that is required to be aggregated with other plans in order to meet the antidiscrimination or coverage rules when the employer maintains a defined benefit plan. Employer contributions attributable to a salary reduction or similar arrangement are not considered employer contributions for purposes of satisfying the minimum contribution rules. The minimum contribution or benefit required in a top-heavy plan must not take into account any social security or similar benefits.

Only the first $200,000 of compensation of a participant can be taken into account in a top-heavy plan for purposes of determining contributions or benefits. The $200,000 limit will be adjusted after 1985 in the same manner as the Section 415 dollar limitations. Top-heavy plans do not have to provide employees covered by collective bargaining agreements with accelerated vesting and minimum benefits, nor does the $200,000 compensation limit apply to such employees.

Regulations will be issued to prevent duplication of benefits for non-key employees, for example, if a non-key employee participates in both a defined benefit plan and a defined contribution plan maintained by the same employer, the employer is not required to provide the non-key employee with the minimum benefit required under the defined benefit plan and the minimum contribution required under the defined contribution plan.

The Section 415 fraction applicable to the dollar limitation for combination plans is reduced from 1.25 to 1 in the case of a top-heavy group unless: (i) the sum of the present value of the cumulative accrued benefits for key employees and account balances of key employees does not exceed 90% of the same amount for all employees and (ii) the minimum benefit is increased. The increase for a defined benefit plan requires that the minimum benefit must be the lesser of (x) 3% times years of service or (y) 30% times the non-key employee's average compensation as described above. The increase for a defined contribution plan requires that the minimum contribution must be 4% of compensation of non-key employees.

If a distribution is made to a key employee before he or she attains age 59½, an additional income tax is imposed equal to 10% of the amount includable in income, unless the distribution is made on account
of death or disability. In addition, benefits must commence to a key employee in the taxable year when he or she attains age 70½, regardless of when the key employee retires.

Because rules dealing with top-heavy plans are qualification rules, the plan itself must contain provisions dealing with top-heavy plans, including minimum benefits, accelerated vesting, and other limitations that apply only to top-heavy plans. All plans, regardless of whether they are currently top-heavy, must contain such provisions, which will automatically take effect if the plan becomes a top-heavy plan. The Treasury is authorized to issue regulations exempting certain plans from containing the top-heavy provisions. It is anticipated that plans covering a large number of employees will be exempted under such regulations.

The rules concerning top-heavy plans apply for plan years beginning after December 31, 1983.

V. ORGANIZATION PERFORMING MANAGEMENT FUNCTIONS

The definition of affiliated service organization under I.R.C. § 414(m) has been expanded to treat as an affiliated service group an organization and another organization if the first organization performs management functions for the second organization, as well as organizations related to the second organization. Under I.R.C. § 414(m), all employers of an affiliated service group are treated as a single employer for purposes of meeting various qualification requirements for pension plans, top-heavy plans, cafeteria plans, medical reimbursement plans, and group-term life insurance plans. The provision is intended to apply to management functions traditionally performed by employees of the organization for which the services are being performed by the management organization.

VI. LEASED EMPLOYEES

Employees leased to another organization will be required to be included as employees of such organization for purposes of meeting the coverage, participation, vesting, benefit accrual, and benefit limitation requirements for pension plans and simplified employee pension plans if the employee performs services for the organization for a period of one year. It is not clear whether the one-year period is a twelve consecutive month period. If the one-year period is a twelve consecutive month period, then the new requirement may be avoided by shifting leased employees from one organization to another before the employee completes the twelve consecutive months of service, and such employee could later be reassigned to the first organization after some minimal period of time.

A leased employee is an employee who provides services to the recipient if: (i) the services are performed by the employee pursuant to an agreement between the recipient and the leasing organization (the
employee's employer), (ii) the services have been performed on a substantially full-time basis for a period of at least one year, and (iii) the services are of a type historically performed by employees of similar businesses.

Under a safe harbor provision, the new employee leasing rules do not apply if the leased employee is covered under a plan maintained by the leasing organization if the plan is a money purchase pension plan with a non-integrated employer contribution of at least seven and one-half percent, which provides for immediate participation and full and immediate vesting. Query whether the safe harbor will avoid any attack by the Internal Revenue Service on such arrangements, or will only avoid application of new I.R.C. § 414(n).

VII. GROUP-TERM PLANS

Effective for tax years beginning after December 31, 1983, a group-term life insurance plan will not receive favorable tax treatment if it discriminates in favor of key employees with respect to eligibility requirements and the types and amount of benefits available. If the plan is discriminatory, the exclusion from income for the first $50,000 of group-term life insurance under I.R.C. § 79 will not apply to key employees. A group-term plan will not be considered discriminatory if: (i) the plan benefits at least 70% of all employees; (ii) at least 85% of all participating employees are not key employees; (iii) the plan benefits employees who qualify under a classification set up by the employer which is found to be nondiscriminatory, or (iv) if the group-term plan is part of a cafeteria plan, the eligibility rules for cafeteria plans are satisfied.

In applying these tests, employees of related employers as defined in subsections (a), (b) and (m) of I.R.C. § 414 are treated as employed by a single employer. The following employees are excluded in applying the tests: (i) those employees with less than three years of service; (ii) part-time or seasonal employees; (iii) employees covered by a collective bargaining agreement; and (iv) employees who are nonresident aliens and who receive no earned income from sources from within the United States.

All benefits under the plan must be available to all employees although the amount of insurance provided to each participant may be a percentage of compensation. A key employee is generally the same type of employee who is considered a key employee for determining whether a pension or profit-sharing plan is a top-heavy plan. However, one percent owners who earn more than $150,000 a year are not treated as key employees if they do not participate in the plan.

VIII. ANTI-KELLER RULE

The Secretary of the Treasury is authorized under new I.R.C. § 269A to allocate income, deductions, credits, exclusions, and other allowances between a personal service corporation and its owner-employees if: (i)
the personal service corporation performs substantially all of its services for or on behalf of one other corporation, partnership, or other entity; (ii) the principal purpose of forming, or availing of, such personal service corporation is the avoidance or evasion of federal income tax by reducing the income of, or securing the benefit of any expense, deduction, credit, exclusion, or other allowance for, any employee-owner which would otherwise not be available; and (iii) allocation is necessary to prevent avoidance or evasion of federal income tax or clearly to reflect the income of the personal service corporation or any of its owner-employees. A personal service corporation is a corporation the principal activity of which is the performance of personal services and such services are substantially performed by owner-employees. An owner-employee is any employee who owns, on any day during the taxable year, more than ten percent of the outstanding stock of the personal service corporation. I.R.C. § 318 will apply in determining ownership, except that “five percent” is substituted for 50% in I.R.C. § 318 (a)(2)(C) dealing with attribution from corporations. Related persons, as defined in I.R.C. § 103 (b)(6)(C), will be treated as one entity. I.R.C. § 103(b)(6)(C) refers to the attribution rules contained in I.R.C. §§ 267, 707(b) and 1563(a), except that 50% is substituted for 80% where it appears in I.R.C. § 1563(a).

IX. SPECIAL ONE MONTH LIQUIDATION PROVISION FOR PERSONAL SERVICE CORPORATIONS

Because Congress believed that many personal service corporations may wish to liquidate as a result of the establishment of parity between plans for self-employed individuals and corporations, TEFRA added a temporary provision that removes some of the obstacles that exist when a personal service corporation liquidates under I.R.C. § 333, the one-month liquidation section. The relief provision applies to liquidations during 1983 and 1984.

As a result, I.R.C. § 333 is to apply to such liquidations regardless of whether the personal service corporation is a collapsible corporation under I.R.C. § 341(a) and no gain or loss will be recognized by the liquidating corporation as result of the distribution of accounts receivable to the shareholders.

The term “accounts receivable” for purposes of this special relief provision has the meaning given the term in the first sentence of I.R.C. § 751(c), dealing with the sale or exchange of interests in a partnership. The term includes any rights (contractual or otherwise) to payment for services rendered or to be rendered to the extent that these rights have not previously been included in income under the method of accounting used by the corporation. Apparently, the term does not include the recapture amount of § 1245 property (depreciable personal property used in the business) and § 1250 property (depreciable real property used in the business). Investment tax credit may be recaptured as a result of the liquidation.
Any disposition by a shareholder of any unrealized receivable received in the liquidation will be treated as a sale at fair market value of the receivable and any gain or loss will be treated as ordinary gain or loss. A disposition includes failing to hold the property in the trade or business which generated the receivable and failing to hold a continuing interest in such trade or business. However, a disposition does not include the transfer of property at the death of the decedent, either to the estate and other beneficiaries of the decedent or to another person pursuant to a right to receive such property under a stock purchase agreement that becomes effective at the death of a shareholder. The unrealized receivables distributed in a liquidation will have a zero basis. Finally, the distribution of unrealized receivables will not increase the earnings and profits of the liquidating corporation.

This relief provision applies to personal service corporations as defined in I.R.C. § 535(c)(2)(B) for purpose of the accumulated earnings tax credit. A service corporation is defined in that section as a corporation the principal function of which is the performance of services in the fields of health, law, engineering, architecture, accounting, actuarial science, performing arts, or consulting.

While this relief provision may have some application, its benefits may be more apparent than real. It has been possible in the past to liquidate a personal service corporation without triggering immediate recognition of income attributable to unrealized receivables by retaining the corporation until the receivables are collected and paying out salaries to the key employees. Most personal service corporations already in existence may be ill-advised to consider liquidation. While the parity provisions may reduce substantially the benefits of incorporating a personal service business, there are still some tax and non-tax advantages for retaining a corporation already in existence. Some of these include limited liability for malpractice of other shareholders and deductions for premiums and benefits paid under group-term life insurance plans, disability insurance plans, and medical reimbursement plans. The owners of the personal service corporation may find that it is more expensive from a legal and accounting standpoint to liquidate an existing corporation than to maintain the corporation as is.

X. WITHHOLDING AND REPORTING ON PENSIONS

Prior to TEFRA, no withholding was required with respect to distributions from pension, profit-sharing and stock bonus plans, tax sheltered annuities, or IRAs, unless requested by the recipient. After TEFRA, withholding will be required with respect to such distributions. Withholding on periodic payments will be based on the recipient's withholding certificate, or if none, based on the rate applicable to a married taxpayer with three dependents. The withholding rate on lump sum distributions will be a ten percent with adjustments made pursuant to regulations to take into account ten-year averaging, capital gain treatment, and the $5,000 death benefit exclusion under I.R.C. § 101(b).

Relief is provided from penalties for failure to withhold before July
1, 1983, if a good faith effort is made to comply. Any amounts actually withheld must be paid over in a timely manner. Any amounts required to be withheld prior to July 1, 1983, but not withheld, must be withheld from payments after June 30, 1983. Case by case exemptions from withholding before July 1, 1983, are authorized and if exempted, deficiencies in amounts withheld need not be made up. Recipients of payments subject to withholding may elect, for any reason, not to have any taxes withheld. The election is revocable.

The payor of such distributions must advise every recipient concerning the withholding rules, regardless of whether any withholding is actually required. Regulations will be issued describing the form and content of the notice. In the case of periodic payments, the notice will be required no sooner than six months before the periodic payment is to begin, and no later than the date the first payment is to be made. For non-periodic payments, the notice is required to be given no later than the date the payment is made, but regulations may provide for earlier notice.

Employers, plan administrators and issuers of insurance or annuity contracts will be responsible for the preparation of reports after 1982 that will include information concerning the following facts about a particular distribution: (i) the total amount of a distribution, (ii) the total amount of deductible and nondeductible employee contributions, (iii) the amount of the capital gains portion and (iv) the amount of the ordinary income portion.

Beginning January 1, 1985, penalties will be imposed for failure to keep records. The penalty will be $50.00 per individual per year, up to a maximum of $50,000 per year for any person required to keep such records.

XI. MISCELLANEOUS PROVISIONS

TEFRA reduces the advantage available to defined contribution plans when the plan integrates with social security. The amount that may be allocated to a participant's account with respect to compensation above the plan's integration level will be determined by the rate paid by the employer for age, survivors, and disability insurance premiums (OASDI), which in 1982 was 5.4%. (The additional 1.3%, for a total F.I.C.A. tax payable in 1982 equal to 6.7%, is the amount attributable to medicare.) The wage base and tax rate that apply for a particular plan year will now be those in effect at the beginning of the year. The new integration rules apply to plan years beginning after December 31, 1983.

A tax-free rollover cannot be made from an inherited individual retirement account or annuity after December 31, 1982. An inherited individual retirement account or annuity is an account or an annuity maintained on behalf of an individual who acquired the account or annuity as a result of the death of another individual. The rule does not apply to a surviving spouse. No deduction is allowed for any amounts paid to an inherited individual account or annuity.
The estate tax exclusion for benefits payable to a beneficiary other than the executor of a deceased participant is limited to $100,000 for persons dying after December 31, 1982. This limitation applies to benefits payable from all types of plans as well as tax-sheltered annuities and IRAs. As under prior law, no estate tax exclusion is available for payments receivable by or for the benefit of the decedent's estate. The reduced exclusion from estate taxes will have a significant impact on estate planning.

Partial tax from rollovers are permitted from IRAs after 1982 if made within sixty days of the date of distribution. Partial rollovers are already permitted from a qualified plan to an IRA.

Effective August 13, 1982, cash surrenders or partial withdrawals from an annuity policy before the annuity starting date will be treated as income to the extent that the cash value of the contract at the time of the surrender or withdrawal exceeds the investment in the contract. This treatment applies to existing annuity contracts, but not to income earned on investments made before August 14, 1982. In addition, withdrawals made after December 31, 1982, may give rise to a five percent penalty if the amount withdrawn is allocable to investments made within the preceding ten years. Amounts withdrawn will be allocable to the most recent investment first. The five percent penalty will not apply to the following types of distributions: (i) a distribution made on or after the date the policyholder reaches age 59½; (ii) a distribution made to a beneficiary or the estate of a policyholder following the death of the policyholder; (iii) a distribution as a result of the policyholder’s disability; (iv) one of a series of substantial equal periodic payments made for life or for a period of at least 60 months; (v) a distribution made from a plan qualified under I.R.C. § 401(a); or (vi) a distribution allocable to an investment in the contract made before August 14, 1982.

Effective for tax years beginning after December 31, 1981, contributions can be made to a defined contribution plan on behalf of a participant who is permanently and totally disabled and is not an officer, owner, or highly compensated employee. This provision must be elected by an employer at such time and in such manner as prescribed by regulations. If the election is made, the annual compensation of such a participant will be deemed to be the annual compensation that was paid immediately before he or she became permanently and totally disabled. All contributions made on behalf of a disabled participant under this provision must be nonforfeitable. Permanent and total disability means that the participant is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months.

TEFRA also contains provisions dealing with retirement savings for church employees and qualified state judicial plans. Because these provisions have limited application, these are not discussed in detail.