CHAPTER V

RECENT CHANGES IN RULES FOR QUALIFIED PLANS

The Tax Reform Act of 1986 substantially changed the rules governing qualified plans. It also changed to an even greater degree the overall tax environment in which the plans operate. This chapter surveys the specific and general ways in which the act will affect qualified plans.

PROVISIONS DIRECTLY AFFECTING QUALIFIED PLANS AND IRAS

The many rule changes for qualified plans and IRAs can be summarized under three headings: tighter limits on the amount of retirement income that can be achieved through qualified plans or IRAs; tighter bounds on the degree to which employers may make distinctions among employees in coverage or in contributions and benefits; and tighter restrictions on the use of qualified plan accumulations for purposes other than retirement income.

Tighter Limits on Retirement Savings

The act limits the amount of retirement income that can be obtained through qualified plans and IRAs in three broad ways: by limits on IRA deductions; by limits on elective deferrals in salary reduction plans; and by lower overall limits on contributions and benefits under qualified plans.

Limits on IRA Deductions. Though all taxpayers may still contribute up to $2,000 each year to an IRA ($2,250 for a combined worker and spousal IRA), starting in 1987 the current-year deductibility of those contributions will be limited among higher-income taxpayers who are participating in qualified plans. (Others who are not qualified plan participants will be able to deduct up to $2,000 or $2,250 regardless of their income.) For married couples in which at least one spouse is participating in a qualified plan, deductible IRA contributions will be phased down from $2,000 ($2,250) at $40,000 of adjusted gross income to zero at $50,000 of AGI. For single taxpayers participating in qualified plans, the comparable AGI levels will be $25,000 and $35,000. Taxpayers whose IRA deductions are fully or partially phased out will be able to make nondeductible IRA contributions up to $2,000

($2,250) and, in so doing, accumulate investment earnings on those contributions on a tax-deferred basis. The IRA contribution limits remain unindexed and, by extension, the new IRA deduction limits are not indexed.

Limits on Elective Deferrals. The act also limits the amount of wages that workers can exclude from current-year taxation by making deposits to employer-sponsored qualified salary reduction plans (that is, so-called "elective deferrals" of current wage income). In general, the limit in 1987 on elective deferrals will be $7,000; beginning in 1988, the $7,000 limit will be adjusted upward each year to reflect inflation over the preceding year. (Until such time as the indexed $7,000 limit surpasses $9,500, the limit on elective deferrals for tax-sheltered annuities sponsored by nonprofit and educational organizations will be $9,500.) Subject to other constraints, however, employees will be able to make nondeductible contributions to employer-sponsored qualified plans that exceed these deduction limits.

Though the act places an upper limit on elective deferrals, it also makes such deferral opportunities more readily available. By removing the requirement that current or accumulated profits are a necessary condition for contributions to a profit-sharing plan in a given year, it makes elective deferrals within the context of 401(k) arrangements--which technically are profit-sharing plans--more available. In addition, the act authorizes for the first time elective deferrals within Simplified Employer Pensions (SEPs), although under quite limited conditions.

Limits on Contributions and Benefits. The act places limits on the amount of overall retirement savings that upper-income employees are permitted to achieve through the medium of employer-sponsored qualified plans. Though inflation indexing of the various dollar income limits applicable to qualified plans will resume in 1988 in accord with prior law, the act continues to freeze the dollar limit on what an upper-income individual may accumulate annually under one employer as qualified defined contribution savings. That limit will remain frozen at $30,000 until it equals one-fourth (rather than one-third) of the comparable defined benefit level; at current rates of inflation, this means that the $30,000 limit will stay fixed for roughly the next 10 years. In addition, the act prohibits compensation in excess of $200,000 from being used in calculating qualified plan contributions or benefits, and it imposes a 15 percent excise tax on distributions from qualified plans and IRAs that exceed, in terms of periodic payments, $112,500 or benefits accrued as of August 1986, whichever is greater. Finally, by requiring that the defined benefit dollar limit (now $90,000) be reduced on a full actuarial basis for benefits payable before age 65, the act restricts what an employer can deduct for the funding of early retirement benefits that accrue after 1986. This last provision may affect some upper-middle-income employees as well as top management.

Tighter Bounds on Permissible Discrimination

The Tax Reform Act restricts the degree to which qualified plans may exclude different kinds of employees, delay vesting, and distinguish among employees in terms of benefits or contributions. In addition, it subjects all tax-favored saving plans, whether they are thrift plans or salary reduction plans, to uniform discrimination rules.

Beginning in 1989, a plan's coverage and plan accruals for highly compensated workers have to be more closely correlated with coverage and plan accruals for other workers. As is the case now, a plan will qualify either if it covers certain stipulated fractions of the sponsoring employer's workers, or, failing that, if it covers a particular class of the employer's workers in a manner that does not discriminate in favor of highly compensated employees, according to standards set forth in regulations. The stipulated fractions are generally similar to those in prior law. 1/ Unlike prior law, however, a plan covering a select class of workers will qualify only if, in addition to satisfying the condition that the class is a representative cross-section of all the employer's workers, the average value of plan accruals for all of the employer's non-highly compensated workers, expressed as a percentage of pay, is 70 percent of the comparable average value for all of the employer's highly compensated workers (the "average benefit" test). Because uncovered workers receive, by definition, no benefits from a plan, they will enter into the average benefit calculations for the two groups at zero value. Hence, a large number of uncovered non-highly compensated workers will disqualify a plan. In addition, though an employer may combine plans for purposes of qualifying them under the tests just described or, instead, choose to apply those tests separately among different lines of business, the act also imposes a new requirement that any one of an employer's plans must cover at least 50 of that employer's workers (or, in situations where an employer's total work force is less than 125, 40 percent of the workers).

1. Under the two fraction tests, an employer's plan will qualify if it covers at least 70 percent of the non-highly compensated workers (the "percentage" test), or if the percentage of non-highly compensated workers covered by the plan is at least 70 percent of the comparable fraction for the highly compensated (the "ratio" test).

The act limits employer latitude with respect to vesting schedules. In the future, workers must vest in qualified plans no later than after five years of service (or seven years in case of a graded vesting schedule). Under prior law, employers had a choice among 10-year vesting, 15-year graded vesting, or a schedule that combined age and years of service.

The act codifies, and also tightens, existing principles that govern the extent to which Social Security may be taken into account in computing either contributions to, or benefits payable from, qualified plans. In general, a year's increase in a worker's benefit under a defined benefit plan for wages above the integration level cannot exceed twice the increase in plan benefits for wages below that level or, if smaller, the increase in Social Security benefits attributable to the employer share of the payroll tax for wages below the integration level. 2/ Similarly, a defined contribution plan's contribution rate for wages above the integration level cannot exceed twice its contribution rate for wages below that level or, if smaller, that rate plus the employer payroll tax for the Social Security cash programs (now 5.7 percent).

Finally, the act specifies some nondiscrimination rules applicable to virtually all types of employer-sponsored tax-favored saving plans--salary reduction plans and traditional thrift plans alike. 3/ When employee before-tax deferrals and after-tax contributions are combined with employer matching and certain nonelective contributions, the resulting amounts among the highly compensated cannot exceed, beyond certain bounds specified in the tax code, comparable amounts among the non-highly compensated. 4/ Because of these constraints on deposits and contributions

2. For defined benefit plans, the act deems that the employer half of the Social Security payroll tax finances a retirement benefit that equals, in the case of a 35-year career worker, 26.5 percent of that worker's average wages below the Social Security wage base (prorated to 0.75 percent for any one year's wages below the wage base).

3. Elective deferrals to 403(b) tax-sheltered annuity plans are exempt from the "average deferral percentage" (ADP) ratio test. The sponsoring employer, however, must make the opportunity to make elective deferrals to tax-sheltered annuities generally available to all employees. Further, any employer- matching matching or nonelective contributions to tax-sheltered annuity plans must comply with the ADP test.

4. In general, the ratio rules for thrift and salary reduction plans are as follows: in situations where the average percent for the non-highly compensated is below 2 percent, the average percent for the highly compensated cannot be more than two times that figure. In situations where the average percent for the non-highly compensated is between 2 percent and 10 percent, the comparable average percent for the highly compensated can be two percentage points higher. Finally, in situations where the

to tax-favored saving plans, the act relaxes coverage requirements for these plans: all workers eligible to participate in such a plan, whether or not they do, will be treated as covered workers for purposes of the coverage tests discussed earlier.

Tighter Restrictions on Using Qualified Plan Assets for Nonretirement Purposes

As discussed more fully in Chapter IV, the act has generalized the principle, first legislated for IRAs, that when taxpayers use qualified plan assets for nonretirement purposes, they should repay the Treasury some portion of the tax advantages that were previously accumulated within those assets. In the case of individuals, beginning in 1987, a 10 percent additional income tax must be paid on qualified plan distributions used for nonretirement income purposes (with the exception of medical expenses). 5/ In some instances, this 10 percent additional tax will fall short of the accumulated tax advantages and will constitute only a partial repayment; in other instances, it will be greater than those advantages and will represent a penalty tax on premature withdrawals. Similarly, when an employer terminates a plan and excess assets revert to the company, it will owe a 10 percent excise tax on the amount of the reversions. These new 10 percent taxes are in addition to the normal liability taxpayers owe for these amounts.

In addition, to discourage wealthy individuals from using qualified plans and IRAs as tax-favored vehicles to build up large bequests, the act has generalized another IRA provision to apply to all qualified plans. In the future, to the extent that any plan does not distribute a requisite amount to a participant who has recently become age 70½, a 50 percent excise tax will be imposed on that amount.

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average percent for the non-highly compensated is greater than 10 percent, the average percent for the highly compensated can exceed that figure by a factor of 1.25. A group's percentage is computed as the average of the percentages for employees in the group, including zero percentages for those not contributing. In the case of elective deferrals in SEPs, however, the 1.25 factor applies in all situations and operates as a limit in individual cases.

5. Retirement is defined as the earliest of the following events: regardless of age, when disability occurs or when annuity payments first begin; a plan's early retirement age if that age is 55 or older; or age 59½.

The act also restricts hardship withdrawals of elective deferrals in 401(k) and other salary reduction plans in cases where the worker is still an active participant in the plan. In the future, such withdrawals will be limited to the past amounts of elective deferrals; any investment earnings attributable to those withdrawals must stay in the plan. As with a preretirement cash-out of an IRA, however, hardship withdrawals of the elective deferrals, unless for qualified medical expenses, will be subject to the 10 percent additional income tax outlined earlier. The act also restricts participant loans from qualified plans more than did prior law.

Summary of Direct Changes

The Tax Reform Act of 1986 continues some trends in public policy toward qualified plans that have emerged in the past five years, partly in response to continuing budget deficits and partly in response to the growing aggregate value of the tax advantages of qualified plans.

First, as just discussed, the act emphasizes the use of qualified plan accumulations for retirement income purposes, rather than for preretirement or bequest purposes. Where accumulations are not being used for retirement, the various recapture taxes will recoup some of the previously lost revenues for the Treasury.

Second, the ability of relatively well-to-do people to accumulate large amounts of retirement income on a tax-favored basis has been further restricted. The effective income limits are generally lower for those types of plans that allow more individual flexibility. The greater the degree of individual flexibility, the lower down in the income distribution the limits are drawn. For example, the new limits on IRAs apply to those in the upper middle class and will become increasingly meaningful over time as wage growth carries more people above the nonindexed income limits. Though the new limit on elective deferrals is indexed and generally less binding than the limits on IRA deductions, it did not exist under prior law, and it will make large amounts of retirement savings less possible through salary reduction arrangements compared with completely nondiscretionary pension or profit-sharing plans. The restrictions on nondiscretionary plans cut in at the highest income levels. Generally, annual benefits in excess of $112,500--among the top 1 percent to 2 percent of those who have earnings above that level--are discouraged.

Third, by imposing new coverage tests, faster minimum vesting schedules, tighter integration rules, and new discrimination rules for salary reduction and thrift plans, the act strengthens the policy objective expressed in ERISA, in the top-heavy rules of TEFRA, and in the changes made by REA. According to this policy goal, the payments from, and tax advantages of, qualified plans should be more evenly distributed by income, job tenure, and similar criteria. In particular, the Congress has reinforced the emphasis it placed on benefit outcomes in the TEFRA top-heavy rules. This emphasis can be seen in the new average benefit ratio test for qualified plans in general and in the average percentage test for tax-favored savings plans in particular. The new integration rules also limit the disparities in qualified plans that can exist by reason of Social Security and represent a more deliberate attempt to correlate Social Security and qualified plans in order to produce certain combined payment results.

Estimates of the effects of these direct changes on the distribution of probable outcomes from qualified plans do not yet exist. Thus, one cannot say precisely how the revised law would affect the simulation of future retirement income presented in Chapter III. The new vesting rules, however, have been estimated to increase plan costs by only about 2 percent to 7 percent (about 0.03 percent of annual compensation, on average). 6/ This relatively small increase suggests that the new rules will have little effect on the typical employee's lifetime pension benefits and, therefore, on employee gains in retirement income from the associated tax advantages. Relatively small gains are especially likely in defined benefit plans where preretirement inflation will continue to render most of the newly vested benefits among short-service workers a nullity. 7/ Though no comparable estimates for the new coverage and integration rules yet exist, their effects in the aggregate are not likely to be very large. Few major plans now exceed the coverage and integration bounds that the act codifies, and the top-heavy rules legislated in TEFRA have already eliminated what were previously the most skewed plans among small and medium-sized employers.

As will be shown later, a potential conflict may exist between this renewed emphasis on a more even distribution of plan benefits and the new tax rate structure.

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6. See Employee Benefit Research Institute, *Issue Brief*, no. 51 (February 1986), p.1.

7. As was shown in the example in Chapter III, the change from 10-year to 5-year vesting in the case of an individual with two jobs--the first for 9 years, the second for 31 years--has only a minor effect on the individual's eventual replacement rate, raising it by only 2.4 percentage points, assuming 3 percent inflation.

STRUCTURAL CHANGES IN THE INCOME TAX AFFECTING QUALIFIED PLANS

The Tax Reform Act of 1986 made significant structural changes in income tax rates and interest deductibility. This section examines the implications of those changes for the formation and maintenance of qualified plans.

Revised Tax Rate Structure

The act replaces the current multibracket tax rate structure with a simplified one that has two broad brackets of 15 percent and 28 percent. 8/ By itself, this probably will not alter the basic demand for qualified retirement plans. CBO's tabulations indicate that marginal rates on wages and salaries will be reduced by only five percentage points or less for most taxpayers (about 97 percent of taxpayers). Among the 3 percent whose earnings exceed $75,000, marginal rates will be reduced an average of eleven percentage points. For those upper-income individuals, saving through qualified plans will nonetheless continue to generate a better rate of return than any other alternative.

But the lower tax rate structure for the upper-income population means that one of the sources from which redistribution in qualified plans is financed has been shrunk. A smaller differential between tax-favored rates of return in qualified plans and taxable rates of return means that there will be less available to maintain the money wages paid to workers who resist

8. Beginning in 1988, for married couples, the 15 percent rate will apply to taxable income under $29,700 and the 28 percent rate will apply to taxable income in excess of that amount. For single filers and head-of-household filers, the comparable breaks between the two brackets will be $17,850 and $23,900 respectively. For married couples with taxable income above $71,900, single filers above $43,150, and head-of-household filers above $61,650, the benefit of the interior 15 percent bracket (that is, 13 percent times $29,700, $61,650, or $17,850) and the value of their personal exemptions will be phased out at a 5 percent surcharge rate. Thus, taxpayers above those levels will face an effective 33 percent tax rate until the phase-outs are complete. Taxpayers who do not itemize will pay taxes if their adjusted gross incomes do not exceed the sum of their standard deductions and personal exemptions. Some examples of the resulting tax-exempt levels are: $4,950 for a single filer; $8,900 for a nonelderly married couple with no dependents; $12,800 for a nonelderly married couple with two dependent children; and $10,250 for a nonelderly head of household with two dependent children. Tax-exempt levels for elderly or blind taxpayers will be higher by $1,200 in the case of married couples or by $750 in the case of single and head-of- household filers. Taxpayers with dependent children who are eligible for the Earned Income Tax Credit will have higher tax-exempt levels than those illustrated here.

any reductions in their wages to pay for contributions to qualified plans, along the lines discussed in Chapter IV. In addition, the ability of the well-to-do to escape the redistribution requirements imposed by the qualification rules has, as shown earlier, been narrowed by both the Tax Reform Act and the top-heavy rules legislated earlier in TEFRA.

The combined effect of these changes--less financing available for any redistribution of the costs of contributions to qualified plans, and tighter nondiscrimination rules--will partly depend on the employment context. Large plans exist mainly in response to a demand among the rank and file (often expressed through their unions) and, quite possibly, because of the production requirements of employers. These plans generally are not very discriminatory under current law and probably contain relatively little redistribution of burden from upper- to lower-income workers. On balance, tax reform probably will not affect the formation and continuation of these plans to any great extent. 9/

Among medium- and smaller-sized employers, tax reform may have different effects. If, as generally thought to be the case, the collective demand for qualified plans is weaker in these settings, the typical employee will be less willing to absorb reductions in current income to finance these plans. Because of the nondiscrimination rules, owners and upper-income management must share some of the gains from the tax advantages of qualified plans with reluctant savers among the rank and file. By reducing the gains available to finance additional compensation of lower-paid workers

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9. Lower section 415 limits, particularly in light of the requirement in the Tax Reform Act of 1986 for strict actuarial reductions in the defined benefit limit for early retirement, could throw increasingly large numbers of middle-management and even highly skilled hourly workers into unfunded non-qualified "excess benefit" plans. Though this result may be appropriate from a revenue or tax equity perspective, it conflicts with the objective of ERISA to assure that retirement plans are securely financed. To compromise these conflicting objectives, it may be necessary to create a new legal creature in the interstices of the Code and ERISA--funded excess benefit plans that do not raise constructive receipt problems once the worker vests but in which the investment income of the funds is taxed at, say, the 28 percent rate. Provisions in the tax code governing the funding of post-retirement medical benefits providesomething of a model for such an arrangement. Employer deductions for contributions would have to be delayed until payment in order for the government not to suffer revenue losses on a cash-flow basis. It is possible, however, that the new tax rate structure and other changes made by the Tax Reform Act of 1986 have so lessened the attractiveness of nonqualified plans from a tax perspective that they will generally disappear.

and at the same time making it more difficult to exclude those workers or limit benefits going to them, the act changes the incentives for the formation and maintenance of qualified plans. One likely response is that fewer traditional pension plans--with their fixed employer commitments--will be established in settings where the rank-and-file demand for retirement savings is weak. Some existing plans may be closed down.

Because thrift and salary reduction plans allow rank-and-file workers to sort themselves according to their saving preferences, such plans may become increasingly attractive in settings where the demand among the rank-and-file for retirement income is not very uniform. In fact, the new provisions making elective deferrals in SEPs and profit-sharing plans more readily available may help spread these arrangements. Even here, however, the act's tighter constraints--more stringent average percentage rules, the $7,000 limit on elective deferrals, the narrow strictures on the use of elective deferrals in SEPs--make formation of such saving plans less attractive to owners and management. When faced with a great many reluctant participants, the small employer may simply resort to some private saving plan--for example, private deferred annuity contracts--and abandon any attempt to sponsor a qualified plan of any sort.

Limits on Interest Deductibility

The act limits interest deductions to no more than a taxpayer's income from investments and to interest on mortgages that do not exceed their bases in two residences (in general, the original purchase price of the residence plus the cost of improvements). 10/ Because of these changes, individuals in qualified plans will be less able to use their participation in such plans merely to reduce their lifetime taxes.

As mentioned in Chapter IV, a taxpayer can borrow money and use it to generate tax-free rates of return in a qualified plan, and then pay back the loan with equivalent proceeds from the plan. Though the taxpayer in this situation has no net gain in assets, he is able to reduce his taxable income over his lifetime by the amount of his interest deductions for the loan. Without interest deductibilty, this tax reduction strategy is not possible. The relatively open-ended nature of interest deductions for mortgages leaves open, however, the opportunity to engage in such behavior, although to a lesser degree than formerly.

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10. Taxpayers are allowed to deduct interest on mortgage or home equity loans that exceed their basis in their residences if the proceeds from those loans are used for medical expenses or college expenses.