The House-passed Tax Reform Act would make significant changes in the pension area, but it would preserve the tax-exempt status of health and welfare benefits.

Tax Reform Passes House of Representatives

After months of deliberation, the House of Representatives approved a tax reform bill on December 17, 1985. The bill (H.R. 3838) would make significant changes in the area of pensions and deferred compensation: a reduction in the section 415 limits for defined benefit and defined contribution plans; a new 15-percent excise tax on distributions from qualified plans prior to age 59½ and a 50-percent excise tax on amounts not distributed before age 70½; a 15-percent excise tax on annual distributions exceeding $112,500 from all tax-favored retirement arrangements; repeal of 10-year forward averaging, with a onetime election of 5-year averaging allowed after age 59½; a $7,000 cap and first-dollar individual retirement account offset for section 401(k) cash or deferred arrangements and 403(b) tax-sheltered annuities, coupled with tighter nondiscrimination rules; prospective elimination of 401(k) plans for tax-exempt and public employers, who would be permitted to establish section 457 plans; and a 10-percent excise tax on excess assets from pension plan terminations. Treasury would be required to evaluate current law nondiscrimination rules for pension plans and make recommendations to Congress by July 1, 1986.

For welfare benefit plans, the House bill would impose new uniform nondiscrimination rules. Favorable tax treatment of employee benefits was retained, and a 2-year extension voted for education assistance and group legal services. In House Ways and Means Committee deliberations, the corporate tax rate was increased by one percentage point to generate revenues to offset retaining the favorable tax treatment of certain employee benefits. The tax reform bill also includes technical corrections to the employee benefit provisions of the Tax Reform Act of 1984 and the Retirement Equity Act of 1984.

The president's goal of a Senate bill more like his proposals means that it may be difficult for the employee benefit community to retain the victory gained in the House to maintain the tax-exempt status of health and welfare benefits. It may be equally difficult to undo the restrictions on pension and capital accumulation programs, even though compromises based upon the provisions of the Retirement Income Policy Act are already being discussed.
Introduction

The latest House action on tax reform is a sequel to a long series of proposals in the past two years. EBRI reported on the first round of the tax reform discussion in its March 1984 Issue Brief (#28), "Basic Tax Reform: Implications for Employee Benefits," It noted President Reagan's 1984 State of the Union tax study mandate and analyzed the comprehensive and consumption tax proposals introduced in the 98th Congress.

The tax reform debate heated up considerably in November 1984, when the two-volume Treasury Department study, "Tax Reform for Fairness, Simplicity, and Economic Growth," was released to the public. Analyzed in EBRI's January 1985 Issue Brief (#38), the study recommended major changes in all areas of the tax law, including extensive changes in employee benefits. The proposal represented a consolidation and refinement of the comprehensive tax proposals presented to the 98th Congress. Even though the entire Treasury package was designed to be revenue neutral, the employee benefit options listed in the document would have raised approximately $80 billion in additional tax revenue over five years.

President Reagan followed in May 1985 with his own tax plan, "The President's Tax Proposals to the Congress for Fairness, Growth and Simplicity." Although the president's package was far more favorable toward employee benefits than Treasury's proposal, many of Reagan's provisions were controversial. The president proposed imposing a "floor" instead of a "cap" on tax-exempt health insurance premiums, retaining 401(k) plans but with tighter nondiscrimination rules and contribution limits, and keeping the tax-exempt status of life insurance, group legal services, and educational assistance, but attaching uniform nondiscrimination rules to the programs.

Subsequently, however, Treasury Secretary Baker proposed the repeal of section 401(k) plans after concern arose that the president's proposal was not revenue neutral. The repeal of 401(k) plans is one of three modifications that Treasury calculated would save almost $23 billion over the next 5 years.


This Issue Brief will examine the mechanics of tax reform, highlight the tax reform legislation approved by the House, and compare the House proposals with earlier tax reform proposals.

Mechanics of Tax Reform

Tax reform proposals, including the latest House proposal, have offered ways to restructure—not lower—the federal tax bill. Most proposals would change the distribution of tax liability among individuals and corporations. This would be done by expanding the tax base to eliminate many current law cases in which a tax exemption, a tax deferral or a special tax rate is allowed for some income. In theory, the broader the tax base, the lower the average rate at which income can be taxed to yield the same amount of revenue.

The chief advantage often cited for expanding the tax base and reducing marginal tax rates is to reduce the influence of tax rates on economic decisions. High marginal tax rates encourage taxpayers to seek tax-favored sources of income—capital gains, for example—and tax-favored uses of income, such as housing. As a result, investment and other economic decisions are often driven by tax advantages as much as by economic returns and productivity considerations.

The general arguments for broadening the tax base have attracted a wide range of political support. Many conservatives support broadening the base as a way of eliminating the income-earning disincentives and market interference of high marginal tax rates. Many liberals support base-broadening as a way of eliminating tax code provisions perceived to primarily benefit the wealthy.

At the same time, however, tax preferences were deliberately built into the tax code to further various social goals, among them enhancing employee and retiree income security. Many long-term economic decisions have, therefore, been predicated on the continued availability of these preferences; many persons could find their economic well-being disrupted were these tax preferences to cease. Furthermore, since many tax preferences are aimed at meeting social needs, if neutrality is achieved, the federal government might find itself, for the first time, making new or additional direct expenditures to meet these social needs.

Comprehensive Income Tax Versus Consumption Tax

While many different tax structures can be designed, the two reform structures that have attracted the most attention in recent policy debates are the comprehensive income tax and the consumption tax. The basic premise behind the comprehensive income tax is that individuals should be taxed on the value of what they produce, as represented by income. A comprehensive income tax would tax both actual and imputed income. Comprehensive income tax proposals include in taxable income not only cash wages but also other items of value received by the employee as compensation. Proposals that could be considered comprehensive tax options include the House bill, the Reagan and Treasury proposals; the FAIR Tax, (S. 409/H.R. 800) introduced by Sen. Bill Bradley (D-NJ) and Rep. Richard Gephardt (D-MO); the FAST Tax, (H.R. 2222/S. 1006) introduced by Rep. Jack Kemp (R-NY) and Sen. Robert Kasten (R-WI); and the Ten Percent Flat Rate Act (H.R. 200/H.R. 2594) introduced by Rep. Mark Siljander (R-MI).
The basic premise behind the consumption tax is that individuals should be taxed not on the economic value they generate but rather on what they consume—or the share of income that is not saved. A consumption tax would exclude all forms of savings from taxable income until the funds were used for consumption, and it would tax all employee benefits that do not result in saving. Various employee benefits that provide insurance protection would, therefore, be taxed. Defined benefit and defined contribution plans would not be taxed, since they result in capital accumulation. Proposals in this category include the Internal Revenue Code Amendment (S. 321) proposed by Sen. Dennis DeConcini (D-AZ) and the Broad-Based Enhanced Savings Tax Act (BEST) (S. 411/H.R. 373) introduced by Sen. William Roth (R-DE) and Rep. Henson Moore (R-LA).

◆ Ways and Means Action

The latest version of tax reform emerged from the Ways and Means Committee on November 23, 1985, after a marathon closed-door session that was the sequel to numerous closed-door sessions, formal and informal caucusing and months of preparatory hearings. The markup of the bill proceeded from a set of options developed by the staff of the Joint Tax Committee in late September 1985 and President Reagan's tax plan. The final language of the bill was agreed to by the Committee on December 3, 1985, after first rejecting a Republican alternative proposal.

Despite reservations about many of the provisions, President Reagan asked House members to approve the Ways and Means proposals. His strategy aimed to win approval for the tax reform measure in the Democrat-controlled House, and then lobby for passage of a bill closer to his proposal. The bill went to the House floor on December 11. The House considered a “rule” that would govern consideration of H.R. 3838. The rule was defeated by a vote of 223 to 202, with only 14 Republicans voting for the rule and with the president. As a result, H.R. 3838 did not come to a vote. House Speaker Tip O'Neill (D-MA) put President Reagan on the spot, telling him that until he had 50 solid Republican votes for passage the bill would not be considered. The president immediately became an active lobbyist, and by Tuesday, December 17, had the votes. But, at a cost. President Reagan made a commitment that he would veto H.R. 3838 if it were sent to him for signature, and said that he would insist on changes. None of these commitments related to employee benefits. At 11:00 p.m. on the 17th the House passed H.R. 3838 by voice vote, making it possible for members to avoid going on record individually.

The bill now goes to the Senate, where congressional tax writers have a broad menu of options from which to choose if they decide to modify the House bill. Table 1 (Issue Brief supplement) compares the House bill with President Reagan’s proposal and with current law. The provisions of the Retirement Income Policy Act (RIPA) (S. 1784, H.R. 3594) by Sen. John Heinz (R-PA) and Rep. William Clay (D-MO) could also be options in consideration of a tax bill. A discussion of other tax reform measures can be found in a comparison of the November 1984 Treasury proposal with current law and other congressional bills that EBRI published in its January 1985 Issue Brief.

◆ Treatment of Tax-Favored Savings

Individual retirement accounts (IRAs), qualified cash or deferred arrangements under section 401(k) and tax-sheltered annuities under section 403(b) of the Internal Revenue Code are the principal tax-favored savings instruments that face substantial changes in the House bill. These instruments enable individuals to supplement their potential retirement income by providing tax incentives to save. Contributions to these accounts lower taxable income, and the contributions and earnings are tax-deferred until withdrawal. If taxable income has fallen since the contributions were made, an individual’s tax may be lower.

Individual Retirement Accounts

Current law enables an individual to exclude IRA contributions from taxable income up to the lesser of earned income or $2,000 each year. Married couples filing a joint return are entitled to deduct $2,250 if one spouse has earned income of at least $2,250 and the other spouse has no compensation in that year. If both spouses have earned income, then the IRA deduction for each spouse is limited to earned income up to a combined total of $4,000.

The House bill would modify the spousal IRA deduction, providing that the total IRA deduction could be up to $2,250, as long as the total earned income of the couple is at least $2,250. For example, under current law a spouse whose only earned income for a year is $50 from jury duty is entitled to an IRA deduction of only $50, not the $250 spousal IRA. Under the House bill, the spouse can receive $50 from jury duty without reducing the $250 spousal IRA.

The House bill would also modify the early IRA withdrawal penalty. Under current law, amounts withdrawn from an IRA before the beneficiary dies, becomes disabled or attains age 59 1/2 are subject to an additional 10-percent tax. The House bill would increase the tax penalty on early withdrawals to 15 percent. However, the House bill waives the tax for any distribution that is part of a scheduled series of level payments under an annuity for the life of the IRA owner (or the joint lives of the owner and owner’s beneficiary).

The House bill would also integrate the elective deferrals to 401(k) plans and 403(b) plans with IRA contributions. Currently, contributions to 401(k) and 403(b) plan contributions are independent of IRA contributions. The House bill would reduce an individual’s IRA deduction by one dollar for each dollar contributed to a 401(k) or 403(b) plan. The reduction only applies to an individual’s elective contribution, not to any employer’s matching contribution. For example, if an in-
individual contributes $1,500 to a 401(k) plan, the IRA deduction limit would become $500. Contributions of more than $2,000 to a 401(k) or 403(b) plan would preclude the use of an IRA. Spousal IRA deductions, however, would not be affected by the working spouse's contributions to the 401(k) or 403(b) plan, unless the nonworking spouse made elective deferrals to the 401(k) or 403(b) plan.

The president's proposal would have enabled a larger spousal IRA. As long as the couple filed jointly and had a combined earned income of $4,000, then the spousal IRA deduction would be $2,000. The president's proposal would also increase the early withdrawal excise tax to 20 percent, unless the early withdrawal distribution was for the acquisition of the participant's first home, the payment of college expenses for a dependent or when unemployed following the cessation of unemployment benefits, in which cases the tax would be 10 percent. The president's proposal would not coordinate elective 401(k) deferrals to IRA contributions.

The provisions under the House bill would be generally effective for taxable years beginning after December 31, 1985. The coordination of elective deferrals with IRA contributions would face a special effective date if the elective deferrals are under a plan maintained through a collective bargaining agreement ratified prior to November 22, 1985. For those situations, the coordination with IRAs would begin with the earlier of the date on which the last of the collective bargaining agreements terminates or January 1, 1991.

Cash or Deferred Arrangements (401(k) Plans) and Tax-Sheltered Annuities (403(b) Plans)

Tax-favored saving through 401(k) plans is particularly attractive. Under current law employees of an employer who has established a qualified cash or deferred arrangement (CODA) under IRC section 401(k) may make pre-tax contributions—in lieu of salary—to the plan. Contributions are often matched by the employer. All monies in the plan and the earnings thereon are tax-deferred until withdrawal.

Public schools and tax-exempt organizations under IRC 501(c)(3) may set up similar plans, known as 403(b) plans. Generally, employers purchase tax-sheltered annuities on behalf of employees, but employers may also make contributions to a custodial account investing in stock of a regulated company.

Employers match employee deferrals in more than 80 percent of 401(k) plans recently surveyed and provide full and immediate vesting of contributions in 46 percent of the plans. Graded vesting is also common (34 percent of plans surveyed), the most typical schedule providing full vesting in 5 years. Eighty-nine percent of 401(k) plans surveyed allow hardship withdrawals from employee contributions; 56 percent of the plans allow similar withdrawals from the vested employer contributions. In addition, an individual can often borrow against his or her 401(k) account or withdraw money from it in the event of a financial hardship.

Participation in 401(k) plans among those offered such plans has been found to be greater than participation in IRAs. In 1982, IRA participation was 17 percent among all nonagricultural wage and salary workers, while the participation rate among eligible employees in 401(k) plans in 1983 was 39.1 percent.

EBRI estimates that as many as 19 million employees are currently eligible to participate in 401(k) plans, and approximately 10 million participate. Data from 1983 indicate that 4.8 million private-sector employees were offered 401(k) plans and 1.9 million employees (39.1 percent) participated with total annual contributions for 1983 of $2.9 billion. Annual contributions were less than $1,200 for 43 percent of the participants; between $1,200 and $1,999 for 29.2 percent; and $2,000 or more for 19.4 percent (8.6 percent of participants did not report contributions).

Whereas the president proposes to repeal 401(k) plans, the House bill would reduce the limit on elective deferrals, tie employee contributions to IRA contributions, tighten nondiscrimination rules and impose a penalty on early withdrawals. The same rules would apply to 403(b) plans.

Under current law, total contributions on behalf of an individual to all defined contribution plans, including 403(b) and 401(k) plans, are limited to the lesser of $30,000 or 25 percent of compensation. Aggregate contributions include any pre-tax contribution, any employer contribution and a portion of the participant's after-tax contribution (if any). A further limit, called an exclusion allowance, applies to amounts contributed to 403(b) plans. Furthermore, current law provides an increased exclusion allowance under 403(b) plans for certain church employees.

The House bill would reduce the aggregate limits to defined contribution plans for each employee to $25,000 and would impose a limit of $7,000 on the employee's pre-tax 401(k) or 403(b) contribution. In addition, the $7,000 salary deferral would be coordinated with an employee's IRA for that year, reducing 401(k) or 403(b) contributions dollar-for-dollar by IRA contributions.


2 Mass Mutual, "401(k) Survey Report," a June 1985 survey of more than 2,000 companies.

3 Ibid., p.4.


5 For more information see "401(k) Cash or Deferred Arrangements," EBRI Issue Brief 46 (September 1985).
The House bill would permit a special “catch up” election for certain employees of an educational organization, a hospital, a home health service or a church to make additional salary reduction contributions to a 403(b) plan.

The House bill would also revise the current 401(k) nondiscrimination rules by redefining the group of highly paid employees and altering the special percentage tests applied to ascertain nondiscrimination. The tests would be extended to 403(b) plans.

Under the House bill, the deferral percentage for the group of highly paid employees may not exceed 125 percent of the deferral percentage of eligible nonhighly paid employees. Alternatively, the deferral percentage of the highly compensated employees cannot exceed the lesser of 200 percent of the deferral percentage of the nonhighly compensated employees or the deferral percentage of the nonhighly compensated employees plus two percentage points.

Current rules do not allow withdrawal of 401(k) and certain 403(b) elective deferrals or the earnings on deferrals prior to age 591/2, death or disability, separation from service, retirement or the occurrence of a hardship. The House bill would continue current law governing withdrawals, but permit hardship withdrawals only from an employee’s elective deferrals. Withdrawals prior to age 591/2, death or disability would be subject to an additional 15-percent income tax.

Additionally the bill would restrict employers from basing contributions and benefits (other than the matching contribution) on the employee’s elective deferral. The bill would also limit minimum-service requirements for eligibility to not more than one year. In addition, the House bill would allow elective deferrals of qualified employer matching contributions for years in which the employer does not have current or accumulated profits.

The net effect of the House bill may be to reduce elective retirement savings. The EBRI/Department of Health and Human Services pension supplement to the May 1983 Current Population Survey found that 37.5 percent of 401(k) participants also had an IRA. Among this group, average 401(k) contributions were $1,720, and average IRA contributions were $1,642. Since, on average, contributions to both are greater than $2,000, the House bill will alter the distribution of contributions. Depending on individual preferences, either average IRA contributions will increase to $2,000 and average 401(k) contributions will decline or all IRA contributions will go into 401(k) plans. Overall participation rates suggest the latter outcome, since participation rates among those offered a 401(k) are greater than the participation rates for those eligible for an IRA. To the extent that IRA deposits and elective 401(k) contributions increase aggregate United States’ savings, these limits would reduce savings. Although the evidence is mixed, recent data suggest that the use of these tax-favored saving plans has encouraged some saving that otherwise would not have existed.

Under the House bill, tax-exempt and public employers would not be able to establish 401(k) plans. Plans adopted and submitted a determination letter to the IRS before November 6, 1985 would be exempt. The 401(k) provisions under the House bill would be effective for plan years beginning after December 31, 1985. Provisions with respect to elective deferrals established under a collective bargaining agreement made prior to November 22, 1985, would not go into effect, however, until the agreement is terminated or by January 1, 1991. The $7,000 limit, however, still applies to plans not under the agreement.

Nondiscrimination Requirements for Employer Matching Contributions

Under current law, employer contributions to any qualified plan must satisfy the general nondiscrimination rule prohibiting contributions or benefits from discriminating in favor of employees who are officers, shareholders or highly compensated. This rule is normally satisfied if employer contributions on behalf of employees are a uniform percentage of compens-

6 The 401(k) plan meets the nondiscrimination test under current law if, for the plan year:
• the average deferral as a percentage of compensation (deferral percentage) for the group of highly compensated employees does not exceed the deferral percentage for the other eligible employees by more than 150 percent, or
• the deferral percentage for the group of highly compensated employees does not exceed the deferral percentage of the other eligible employees by more than 250 percent and the deferral percentage of the highly compensated does not exceed the deferral percentage of the nonhighly compensated employees plus three percentage points.

Highly compensated employees are those whose pay is in the top one-third of all employees compensated by the employer.

7 An employee would be considered highly compensated for the plan year if during the current plan year or either of the two preceding plan years the employee:
• is a 5-percent owner of the employer;
• earns more than $50,000 in annual compensation; or
• is a member of the top-paid group of the employer.

The top-paid group would include all employees who are in the top 10 percent of all employees on the basis of compensation and who earn more than $20,000 a year. However, if the employee earns less than $35,000 and is not in the top 5 percent of all employees based on compensation then that employee would not be included as a part of the top-paid group.

The House bill would require that qualifying employer matching contributions, as a percentage of compensation for highly compensated employees be limited to 125 percent of the average contribution made for other employees, or the lesser of (1) 200 percent of the average percentage for the nonhighly compensated employees or (2) the average percentage for the nonhighly compensated employees plus two percentage points. A qualified employer matching contribution is nonforfeitable; ineligible for withdrawal prior to attainment of age 59 1/2, death, disability, separation from service, or bona fide plan termination; and no greater than 100 percent of the employee's mandatory contributions.

The House bill would distinguish between annuity contracts held by a corporation or a trust and those held by the employer. If the employer is the nominal owner of the annuity contract on behalf of the employees, then the contract will be treated as owned by the employer, and contract income is treated as ordinary taxable income received by the employee. If, instead, the annuity contract is held by a corporation or trust as an agent for employees, the contract will be treated as an annuity contract for federal income tax purposes.

In addition, the bill would stipulate that the additional income tax on withdrawals before age 59½ conform to the 15 percent tax proposed by the House bill on early withdrawals from IRAs and other tax-favored savings arrangements.

These provisions would be effective for contributions made or withdrawals occurring after December 31, 1985. The additional income tax provision on early withdrawals will be exempted for those who, as of November 6, 1985, have begun receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments. The individual would, however, be subject to the present law while under the exception.

The bill would also clarify that the owner of a deferred variable annuity would be treated as owning a share of the assets and income of the account underlying the variable contract. Consequently, in this case, the owner would not be taxed on the unrealized appreciation of assets underlying the variable contract.

If, instead, the annuity contract is held by a corporation or trust as an agent for employees, the contract will be treated as an annuity contract for federal income tax purposes.

Deferred Annuity Contracts
Under current law, income earned from deferred annuities are tax-deferred until distributed. In general, amounts received by the owner of an annuity contract before the annuity starting date are taxed as ordinary income to the extent that the cash value of the contract exceeds the owner's investment in the contract. A portion of each distribution received after the annuity starting date is also taxed as ordinary income. Distributions before the employee attains age 59½ are subject to a 5 percent additional income tax. This tax penalty does not apply, however, if the distribution is made periodically over a period of at least 60 months.

The House bill would distinguish between annuity contracts held by a corporation or a trust and those held by the employer. If the employer is the nominal owner of the annuity contract on behalf of the employees, then the contract will be treated as owned by the employer, and contract income is treated as ordinary taxable income received by the employee. If, instead, the annuity contract is held by a corporation or trust as an agent for employees, the contract will be treated as an annuity contract for federal income tax purposes.

In addition, the bill would stipulate that the additional income tax on withdrawals before age 59½ conform to the 15 percent tax proposed by the House bill on early withdrawals from IRAs and other tax-favored savings arrangements.

These provisions would be effective for contributions made or withdrawals occurring after December 31, 1985. The additional income tax provision on early withdrawals will be exempted for those who, as of November 6, 1985, have begun receiving benefits under the contract pursuant to a written election designating a specific schedule of benefit payments. The individual would, however, be subject to the present law while under the exception.

The bill would also clarify that the owner of a deferred variable annuity would be treated as owning a share of the assets and income of the account underlying the variable contract. Consequently, in this case, the owner would not be taxed on the unrealized appreciation of assets underlying the variable contract.

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9 The employer matching contribution can be adjusted in an integrated plan for certain social security benefits.
The president's proposal is similar to the House bill in terms of taxing increases in excess of the contract's cash value. However, the president's proposal would not differentiate between different types of nonhuman ownership for purposes of federal income taxation. The president's proposal would treat all deferred annuity contracts the same.

**Minimum Standards for Qualified Retirement Plans**

**Nondiscrimination Rules**

The president's tax proposals would not alter current nondiscrimination rules for defined benefit plans or top-heavy plans, but the House bill would. The president's proposal would alter the coverage requirements, while the House bill would not. The House bill would require that the Department of Treasury conduct a study on the effect of the current laws governing coverage tests, and report by July 1, 1986 on how coverage rules might be changed.

Under current law a profit sharing, stock bonus, pension or annuity plan must be nondiscriminatory in coverage to qualify for tax-favored treatment. Acceptable coverage is either met with a percentage test or a classification test. Under current law the percentage test is met if the plan provides benefits to at least 70 percent of all nonexcludable employees or at least 80 percent of all eligible employees if 70 percent of all nonexcludable employees are eligible. Under current law the classification test is met if the Secretary of the Treasury de-
termine that the plan covers a classification of nonexcludible employees that is not discriminatory in favor of employees who are officers, shareholders or highly compensated.

Under current law, additional tests are applied to determine whether the contributions or benefits under the plan discriminate in favor of highly compensated employees. Plans may not discriminate in favor of highly paid participants over lower-paid as a percentage of compensation.

Under current law, the portion of each employee's Social Security benefits paid by the employer may be included in the calculation that determines the percentage of nondeferred compensation.

Current law requires that all employees of corporations that are members of a controlled group of corporations or all employees of trades or businesses that are under common control be aggregated and treated as if employed under one employer. The current tax code provides guidance for determining whether different plans are comparable in terms of benefits and contributions and which employees are excludable from the percentage and classification tests. Current law enables a plan to exclude certain employees who have not yet worked the minimum service period or not yet attained minimum age. In addition, those not covered by the plan but working for the employer under a good faith collective bargaining agreement may be excluded. Finally, it should be noted that current law provides no nondiscrimination rules for an employer's tax-sheltered annuity program.

The House bill calls for a study of coverage and expansion of current nondiscrimination rules to tax-sheltered annuities. In addition, the House bill would add special coverage and nondiscrimination rules for tax-sheltered annuities that have elective deferrals and qualifies those employers subject to the nondiscrimination rules.

The House bill applies the coverage and nondiscrimination rules of present law to tax-sheltered annuities to which the employer makes contributions. If the tax-sheltered annuity allows elective deferrals, the House bill would provide for special coverage and nondiscrimination rules. To ensure that the opportunity to make elective deferrals is available to all employees, the bill would provide that the employer generally not require a minimum dollar or percentage of compensation amount as a condition of participation.

Under the House bill these nondiscrimination rules would go into effect for years beginning after December 31, 1985. However, with respect to tax-sheltered annuity programs maintained by state and local governments, these nondiscrimination rules would apply for plan years beginning after November 21, 1987.

The president's proposal would explicitly change the coverage rules by repealing the classification test and changing the percentage test. The percentage test proposed by the president would limit the percentage of the employer's prohibited group members benefitting under the plan to 125 percent of the percentage of other employees benefitting under the plan. The prohibited group member would be an employee that over the last three years was either an owner of at least one percent; receiving over $50,000 in annual compensation; among the top 10 percent in terms of compensation or who is among the highest-earning three employees, unless earning less than $20,000; or a family member of another prohibited employee.

The House bill would also revise rules for plans in which 60 percent or more of the accounts or accrued benefits were attributable to key employees, i.e., top-heavy plans. Under current law, a top-heavy plan must have an accelerated vesting schedule and meet specific minimum benefit or plan contribution requirements to be tax-preferred. Current law requires a top-heavy plan to accrue benefits for participants at a rate that meets one of three alternative schedules. The House bill would require that the fractional benefit accrual rule be the sole schedule used to determine whether the plan is a top-heavy plan.11

**Benefit Withdrawals**

Under current law, tax-preferred retirement plans have minimum requirements concerning the timing and amount of before-death and after-death distributions of benefits. The timing differs for qualified plans, tax-sheltered annuities and IRAs. The House bill would make the timing rules the same, following the rules currently established for IRAs. This modification is similar to that proposed by the president. The House bill would also establish an excise tax, as an alternative to plan disqualification, for failure to satisfy the minimum distribution rule.

Under current law, distribution of benefits from a qualified plan must begin by April 1 of the calendar year following the calendar year in which the participant reaches age 70½, or, for participants who are not 5-percent owners, the taxable year in which the participant retires (if this is later). Distributions from an IRA are required to begin by April 1 of the calendar year following the calendar year in which the owner reaches age 70½. Plans that fail to satisfy these rules may be disqualified. The House bill would impose a 50-percent nondeductible excise tax on employees for the amounts required to be distributed. Uniform minimum distribution rules under the House bill would apply to distributions made after December 31, 1985. However, those who are not 5-percent owners and who have attained age 70½ by January 1, 1988, may defer the commencement of benefit payments until retirement.

11 The fractional benefit accrual rule provides that each participant's accrued benefit at the end of any year must be at least equal to the participant's total years of participation divided by the total number of years of participation before normal retirement age.
In addition, an employee would not be subject to the 50-per-
cent excise tax for failure to satisfy the minimum-distribution
requirements merely because distributions are made in accor-
dance with a designation made before January 1, 1984.

Lump-Sum Distributions
Under current law a lump-sum distribution from a qualified
plan may only be taken if it is the employee's total accrued
benefit and is provided when the employee dies, attains age
59 1/2, becomes disabled or separates from the employer's ser-
vice. The portion of the lump-sum distribution resulting from
plan contributions prior to 1974 qualifies for capital gains
treatment and for 10-year forward income averaging. The propor-
tion of the lump-sum distribution attributable to contribu-
tions after 1974 is eligible only for 10-year forward aver-
aging.

The House bill would repeal 10-year forward averaging. For
individuals age 59 1/2 and over, one lifetime use of forward in-
come averaging would be permitted, with the averaging pe-
riod reduced to 5 years. For individuals who attain age 50 by
January 1, 1986, one election on distributions received prior to
age 59 1/2 to use 5-year averaging would be allowed.

The provisions would generally be effective for distributions
received after December 31, 1985. A transition rule would
apply for individuals who separate from service in December
1985 and receive the lump-sum payment in January 1986 to
the distribution as received in 1985 and to claim 10-
year averaging.

The House bill would phase out pre-1974 capital gains treat-
ment over a 6-year period. Individuals age 59 1/2 and over
could claim capital gains treatment on the pre-1974 portion
of the lump-sum pursuant to the 6-year phase out. Individuals
who have attained age 50 by January 1, 1986 would be able to
make one election to claim pre-1974 capital gains treat-
ment pursuant to the 6-year phase out. A special transition
rule permits individuals who separate from service in Decem-
ber 1985 and receive a lump-sum distribution in January 1986
to elect to treat the distribution as received in 1985 and to
claim capital gains treatment on the pre-1974 portion.

The House bill would also modify what are known as "basis
recovery" rules, which govern distributions from plans that
include aftertax employee contributions. Current law treats
initial distributions prior to the annuity starting date as the
recovery of the aftertax employee contributions. Distributions
after the annuity starting date are treated partially as taxable
income and partially as recovery of employee contributions.
Under a special rule, if an individual will receive all em-
ployee contributions within the first 3 years after the annuity
starting date, the individual can elect to recover the full
amount as a return of aftertax contributions.

The House bill would reverse the basis recovery order so that
distributions prior to the annuity starting date would be
treated as taxable employer contributions plus earned income,
rather than the nontaxable employee aftertax contributions.
In addition, the special 3-year basis recovery rule would be
repealed so that each distribution is treated as part payment
of income and part recovery of employee contributions.

Loans under Qualified Plans
The House bill would reduce the size and scope of tax-
exempt loans from qualified plans. Under current law, loans
are treated as taxable distributions unless the loan is less than
a specific amount and is repaid within a specified time, in
which case the loan is tax-exempt. Under current law the
loan is tax-exempt if it does not exceed the lesser of $50,000
or the greater of $10,000 or one-half the participant's accrued
benefit. The loan must be repaid within 5 years or a reasona-
ble time period if the loan is for a owner-occupied home pur-
chase or home improvement. Interest paid on the loan is
deductible.

The House bill would reduce the $50,000 limit by the high-
est outstanding loan balance of the prior 12 months. In addi-
tion, the 5-year repayment rule exception is limited to loans
for first-time purchases of owner-occupied homes. Further-
more, repayment must be based on a level amortization
schedule over the permissible repayment period. For loans se-
cured by elective deferrals from a 401(k) plan or tax-sheltered
annuity, or, in the case of key employees of qualified plans,
the House bill would provide for a deferral of the loan inter-
est deduction, rather than a current interest deduction. The
deferral would be accomplished by increasing the participant's
contributions under the plan by the amount of the interest
paid.

The provisions would be effective for amounts received as a
loan after December 31, 1985. Any renegotiation, extension,
renewal or revision after December 31, 1985, of an existing
loan is treated as a new loan on the date of the change.

♦ Tax Deferral under Qualified Plans

Limits on Contributions and Benefits
Under current law, section 415 of the IRC limits overall con-
tributions and benefits that may be provided to an individual
under qualified plans and tax-sheltered annuities. Annual ad-
ditions on behalf of a participant in a qualified defined con-
tribution plan are limited to the lesser of 25 percent of
compensation or $30,000. Annual additions include employer
contributions, forfeitures and employer contributions that ex-
ceed 6 percent of compensation. The House bill would re-
duce the dollar limit on annual additions to $25,000 and
treat all employee contributions as annual additions.

Under current law, annual benefits payable on behalf of a
participant from a qualified defined benefit plan are limited to
the lesser of 100 percent of compensation or $90,000. This
limit is reduced proportionately for those with less than 10
years of service. The House bill would reduce the dollar limit
to $77,000.
Cost-of-Living Adjustments—Adjustments to the defined benefit and defined contribution limits for the cost of living are scheduled under current law to become effective beginning in 1988. For defined benefit plans, the House bill would index the limits beginning in 1988 to reflect cost-of-living increases since 1986. The limit for defined contribution plans would remain fixed until the limit equals 25 percent of the defined benefit plan limit; thereafter, the defined contribution plan limit would be adjusted to maintain this 25 percent differential.

Combined Plan Limits—Under current law, the combined limit is the lesser of 125 percent of the separate plan dollar limits or 140 percent of the separate plan percentage limits. The limit for combined plans under the House bill would remain the same. The House bill would, however, impose a new 15-percent excise tax on distributions from all tax-favored plans in excess of the greater of $112,500 or 1.25 times the defined benefit plan dollar limit. The president's proposal would repeal the combined plan limit for all nonstock plans but impose a similar excise tax (reduced to 10 percent) on aggregate annual distributions.

Deductions for Contributions to Qualified Plans
Under current law, employer contributions to profit sharing and stock bonus plans are deductible as a business expense up to 15 percent of aggregate employees' compensation in the current year. If contributions are less than or greater than the 15-percent limit in a particular year, the excess may be carried forward and used in some other year. The House bill would repeal the "limit carry-forward" provision for contributions to profit sharing and stock bonus plans and impose a 15-percent annual nondeductible excise tax on employer contributions in excess of the deductible limits. In addition, the 15-percent limit would be applied to total compensation including the employer's share of Social Security taxes.

The president's proposal would also repeal the "limit carry-forward" provision, except under certain "retirement type" profit sharing plans, and the 15-percent compensation limit would also be modified. The president's modification would require the limit to apply on an individual, rather than an aggregate, basis.

Combined Plan Limits—Under current law, if an employer maintains a defined benefit or money purchase pension plan and a defined contribution plan, then the employer's annual deduction is limited to the greater of the amount needed to satisfy the minimum funding requirements of the pension plan or 25 percent of the aggregate compensation of the covered employees. The House bill, like the president's proposal, would apply the combined plan limit to any combination of defined benefit and defined contribution plans.

Effective Dates
The effective dates for the provisions reducing the overall limits and the tax on excess distributions would begin after December 31, 1985. However, with respect to limits, a plan will not fail to qualify prior to January 1, 1988 merely because the plan provides benefits or contributions that, though not exceeding the overall limits in effect prior to the amendments made by the bill, exceed the new limits. In addition, no later than the first plan year beginning after December 31, 1987, benefits in excess of the greater of the amended limit or an individual's current accrued benefit would have to be reduced, to conform to the limits as amended. Collectively bargained plans ratified before November 22, 1985 have until either the agreement terminates or January 1, 1991, whichever is sooner.

To ensure that previously accrued benefits under a defined benefit plan would not be reduced because of the House bill, special transition rules would be provided. Basically, if an individual's current accrued benefit exceeds the dollar limit in the House bill, but not that under current law, then the applicable dollar limit for the individual would be equal to the current accrued benefit. This rule would apply to those participating in a plan before January 1, 1985 in a plan in existence on November 6, 1985. Subsequent salary increases or cost-of-living increases would not be taken into account in computing the current accrued benefit.

The House bill provisions relating to deduction limits would generally apply to employer taxable years beginning after December 31, 1985. However, certain unused pre-1986 limit carry-forwards would be exempt.

Asset Reversions
Finally, the House bill would impose a tax on asset reversions. Under current law, prior to the satisfaction of all liabilities to employees and beneficiaries, assets held in a qualified plan generally can be used only to provide retirement income to beneficiaries. Assets remaining in the plan upon plan termination, however, may revert to the employer after all plan benefits accrued to the date of plan termination have been paid. The House bill would impose a nondeductible excise tax of 10 percent on the reversion to the employer pursuant to the plan termination occurring after December 31, 1985. This proposal is the same as the president's.

Employee Stock Ownership Plans
Employee stock ownership plans (ESOPs) are qualified retirement plans designed to invest primarily in the employer's securities. Employees acquire stock without investing their own money and employers are provided a tax-favorable financing vehicle. There are two basic types of ESOPs, a tax-credit ESOP and a leveraged ESOP. Under current law, employers with a tax-credit ESOP use contributions to finance the plan. The credit cannot exceed 0.5 percent of the compensation paid or accrued with respect to employees participating in the ESOP. Within certain limits, the employer also receives a tax credit for the costs of establishing and administering the plan. In a leveraged ESOP, the ESOP trust borrows to purchase employer securities. The employer contributes to the trust so
that it meets the debt payments on the loan. In this case, in
general, the contributions are deductible without regard to
limits on other qualified plans.

Under current law the employees are not taxed on employer
contributions to an ESOP or the accumulated income of the
trust until the securities are distributed. A tax credit ESOP
must hold employer securities for a least 7 years before distri-
bution and a leveraged ESOP may be able to distribute the
securities after 2 years. Typically, the distribution is made af-
after the employee separates from service. If there is no estab-
ished exchange for the securities, the recipient of the
distributed stock is entitled to sell the securities to the em-
ployer using a fair market valuation formula.

ESOPs must pass through voting rights on employer securities
allocated to the accounts of the participants if the security is
a registration-required class security. The ESOP may pass on
the dividends through to the shares allocated to the partici-
pants.

Congress provided additional tax incentives for ESOPS in the
1984 Deficit Reduction Act (DEFRA). These provisions in-
clude:

- Banks, insurance companies, and other commercial lenders
  may exclude half the interest paid or accrued on a loan
  used by an ESOP to purchase certain securities.
- Corporations may deduct the dividends from employer
  stock actually paid to participating employees in their
  ESOP accounts.
- Taxpayers who sell employer stock to an ESOP may defer
  the capital gains tax on the gain, if immediately after the
  sale the ESOP owns more than 30 percent of the employer
  stock and the proceeds are invested in the securities of a
  private-sector employer.
- An ESOP may assume the estate tax liability of a deca-
dent, if the decedent's securities are transferred to the
  ESOP.

The House bill would restrict the tax advantages to employers
from using ESOPs and would try to ensure employee rights of
ownership. In general, the House bill would increase the
vesting schedule, modify the nondiscrimination rules, expand
the pass-through to employees of voting rights, enable partici-
pants to diversify their ESOP holdings, modify the distribu-
tion and selling requirements and repeal the special tax
provisions provided under DEFRA.

Under current law, ESOPs must comply with one of the
three minimum vesting schedules that other qualified pension
plans must meet. In the first option, vesting must be 100 per-
cent at the end of 10 years (cliff vesting) if there is no partial
vesting beforehand. The second option, called graded vest-
ing, begins at 25 percent after 5 years and is complete within
15 years of service. Finally, there is the rule of 45 where one
is 30-percent vested when he or she has at least 5 years of
service reaches an age where age plus service equal 45. For
each year of service thereafter, vesting increases an additional
10 percent.

The House bill would modify current law by changing the
vesting rule to a special 10-year graded vesting schedule. The
proposed schedule would require 20-percent vesting after the
completion of 6 years of service and an additional 20-percent
vesting each year thereafter until 100 percent vested after 10
years of service.

The House bill would limit the amount of employer contribu-
tions that may be provided to employees who are officers,
shareholders or highly compensated. Specifically, no more
than one-third of the employer's contributions during the
year may be allocated to the group of employees consisting of
officers, 10-percent shareholders or highly compensated. An
individual would be considered highly compensated if com-
ensation exceeds an amount equal to 200 percent of the dollar
limit on annual additions to a defined contribution plan.
In 1985, this threshold would be $60,000 under the House
bill. A 10-percent shareholder is one who owns more than 10
percent of the total combined voting power of all classes of
voting stock or more than 10 percent of the total value of
shares of all classes of stock (other than stock held by quali-
fied plans).

For ESOPs maintained by employers that do not have regist-
ration-type securities, the House bill would modify current
tax law by giving employees voting rights. For participants
with less than 10 years of service the House bill would re-
quire that they have the right to direct the trustee to vote
allocated securities with respect to any corporate matter that
must, by law or charter, be decided by more than a majority
vote. For those with 10 or more years of service, the House
bill would provide that these participants have the right to
direct the trustee to vote allocated securities on all issues.

The House bill would also require the ESOP to offer partici-
pants the opportunity to diversify their account balance. Par-
ticipants age 55 with at least 10 years of service would be
able to direct diversification of up to 25 percent of their ac-
count balance each year for 5 years. If at age 55, a partici-
pant does not have 10 years of service, then the period in
which diversification can occur is after the tenth year until
age 60. Those age 60 can diversify up to 50 percent of their
account.

Under current law, the distribution of benefit payments must
begin within 60 days after the plan year in which the em-
ployee attains normal retirement age or age 65, whichever is
earlier. The House bill would modify this by requiring distri-
bution no later than 60 days after the end of the plan year 2
years after the participant separated from service or one year
after the securities acquisition loan was paid off.

The House bill would repeal the special ESOP tax credit for
the years after 1985. The tax credit of 0.05 percent is sched-
uled to expire under current law in 1987. In addition, begin-
ning in 1989 the House bill would repeal the special tax incentives for ESOP financing provided though DEFRA.

The effective dates for the additional qualification requirements would apply to ESOPs adopted after December 31, 1985. For those in existence prior to January 1, 1986, these requirements would apply to contributions or securities purchased after December 31, 1985. This means that ESOP plan amendments would not be necessary for ESOPs for which no additional contributions are made. The repeal of the tax credit would apply with respect to compensation paid or accrued after December 31, 1985.

The president's proposal with respect to ESOPs is somewhat different. Limits on deductions to leveraged ESOPs could not be greater than 20 percent or less than 8.3 percent of the original balance or, alternatively, an amount of equal annual payments that would repay the loan in 10 years or less. In addition, the deductible principal payments would be limited to 25 percent of eligible employees' aggregate compensation, although nondeductible payments would be deductible in a subsequent year (subject to the 25-percent limit).

The trust would be required, under the president's proposal, to make annual distributions of securities held by the trust and the dividends earned to the participants. Alternatively, the trust could retain nominal ownership, but all voting rights would have to be distributed to the participants. In the House bill, the trust could retain both the stocks and the voting rights to those stocks.

◆ Treatment of Nonwage Compensation

In contrast to the president's proposal of November 1984, the House bill would maintain the current tax-free status of employer-provided nonwage benefits, but would impose new nondiscrimination rules on those benefits. In particular, the tax-free status of employer-provided health insurance, group term life insurance and death benefits would be retained. In addition, the tax exclusions for employee educational assistance and prepaid legal service benefits would be extended for 2 more years. These exclusions are scheduled to expire at the end of 1985. However, the House bill would allow the tax exclusion for vanpooling to expire at the end of 1985, and the bill would impose a $5,000 tax-free limit on employer-provided dependent care assistance and require employer-provided gifts to be included in gross income.

Health Insurance

Health insurance is one of the most common voluntary employee benefits provided to workers in the United States. In 1984, nearly 78 percent of civilian nonagricultural workers reported receiving health care coverage from an employer-sponsored health insurance plan. Rates of employer-provided coverage are particularly high among workers who are employed full-time throughout the year. In 1984, more than 85 percent of full-time, full-year workers were covered by an employer-provided health plan.13

Under current tax law, employer contributions to health insurance plans for an employee or dependents of an employee are excluded from the employee's gross income. The House bill would not change the current treatment of premiums paid by an employer on the behalf of an employee, although tax reform options proposed earlier this year would. For instance, the Treasury Department favored limiting the tax exclusion of premiums to $70 a month for a single person and $175 a month for a family. Under the president's tax proposals, the first $10 per month of employers contributions for single coverage would be taxed and the first $25 per month of family coverage would be taxed.

The exemption of employer-provided health insurance premiums under current law applies to employer contributions to both insured and self-insured plans. To be tax-qualified, however, self-insured plans must satisfy specific nondiscrimination rules. These rules are intended to ensure that no single class of employees receive favorable treatment in terms of coverage or benefits. Employer-provided health benefits under an insured plan, currently are not subject to nondiscrimination rules. The House bill would remove this distinction, providing nondiscrimination rules for employer-provided health benefits, regardless of the insurance mechanism used.

The House bill would also require that the Treasury Department conduct a study of abuses in the health insurance area and make recommendations for changes in the current nondiscrimination rules. Treasury would be required to report the results of their study and make recommendations by July 1, 1986.

Life Insurance

Currently, 98 percent of employees in medium and large firms receive employer-provided life insurance. Under current law, employees can receive no more than $50,000 of life insurance tax-free per year. While neither the House bill nor the president's proposal would change this limit, the Treasury proposal would have included all employer-paid life insurance premiums in employees' taxable income.

Cafeteria Plans

Almost 5 million employees are covered by plans that offer a choice among benefits or between various benefits and

13 Ibid.

Nonwage Compensation Provisions of H.R. 3638

- Retain present law tax exclusions for group-term life insurance, death benefits and dependent assistance
- Extend for 2 years education and legal assistance
- Allow vanpooling tax exclusion to expire
- Establish comprehensive nondiscrimination rules for all statutory fringe benefits
- Modify cafeteria plan nondiscrimination rules

Cash.\textsuperscript{15} Under current law, cafeteria plans are subject to nondiscrimination rules for coverage as well as contributions and benefits. In addition, in plans where a participant is offered a choice between cash and nonwage benefits, the availability of cash does not require that income taxes be paid on the cash value, unless cash is taken from the plan.

Coverage, or eligibility, is not discriminatory under current law if the plan benefits a class of employees that does not discriminate in favor of employees who are officers, shareholders or highly compensated, and employees who have completed at least 3 years of service are eligible to participate.

Under current law, contributions and benefits are not discriminatory for plans not provided under a collective bargaining agreement if the following tests are met: (1) contributions on behalf of each participant include either (a) 100 percent of the cost of health coverage of the majority of highly compensated participants who are similarly situated, or (b) 75 percent of the cost of health benefit coverage of the similarly situated participant with the highest cost health benefit coverage; and (2) contributions or benefits with respect to other benefits under the plan bear a uniform relationship to compensation.

The House bill would modify the nondiscrimination test for contributions and benefits but would preserve the present-law eligibility test. In addition, the nondiscriminatory tests applicable to all statutory fringe benefits would now also apply.

In addition to the applicability of each specific statutory nondiscrimination test, the president's proposal would include special nondiscrimination rules for the provision of medical, legal or dependent care expenses under a reimbursement account. Under the president's proposal, a reimbursement account for either medical, legal or dependent care expenses would satisfy the nondiscriminatory coverage and benefits tests if the average reimbursement for the highly compensated group of participants does not exceed 125 percent of the average reimbursement for nonhighly compensated participants. The reimbursements for medical, legal or dependent care expenses would be aggregated. Reimbursements for insurance premiums would not be permitted under reimbursement accounts, and each level or type of benefit elected under the cafeteria plan would be treated as a separate plan.

Nondiscrimination Rules

The House bill would establish comprehensive nondiscrimination rules for statutory fringe benefits and welfare benefit plans. These provisions would be effective for years beginning after December 31, 1986. In general, under the bill eligibility to participate could not discriminate in favor of highly compensated employees, and at least 90 percent of all employees would have to be eligible to benefit under the plan.\textsuperscript{16} If participation is less than 90 percent, the contributions provided on behalf of highly compensated employees would be taxed; the benefits of other employees would remain tax-exempt. Part-year or part-time employees or those included in the plan because of a collective bargaining agreement, could be excluded from the 90-percent test.\textsuperscript{17}

The bill would also establish a benefits test, one for insurance-type plans and a separate one for other plans. For insurance-type statutory benefits, such as health or life insurance, coverage must be the same for all employees. The plan would be considered discriminatory if more than 25 percent of the employees benefiting from the accident or health plan were highly compensated and less than 75 percent of the employees eligible to participate benefit from the plan. For other types of nonwage benefits (e.g., qualified group legal services, educational assistance programs and dependent care assistance programs) benefits available to any highly compensated employee would have to be available on the same terms and conditions to all other employees eligible to participate. In particular, the average benefit provided to nonhighly paid employees would have to be equal or exceed 80 percent of the average benefit provided to highly compensated employees.

For the purposes of applying the nondiscrimination test, generally all employees of all employers under common control would be treated as employed by a single employer. An exception to this is provided if the employer for bona fide business reasons operates separate lines of a business or separate operating units and if each line of business or operating unit has at least 1,000 nonexcludable employees.

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16 Highly compensated employees are defined here in the same way as under the nondiscrimination rules for qualified plans. See footnote 7.
17 Part-year, part-time employees are those who have worked less than 180 days or who normally work less than 20 hours a week or less than 1,000 hours a year.
Treatment of Unemployment Compensation

During the past three decades, employment termination benefit programs have escalated in number and in benefit payments. In 1950, benefits from these programs—excluding all retirement benefits—totaled $3 billion or 2 percent of wages and salaries. In 1980, they were nearly $70 billion annually or about 5 percent of total wages and salaries.\(^18\)

Under current law, income received as compensation when not working due to employment termination, job layoffs, plant closings, illnesses, disabilities and work accidents receives a limited exclusion from income taxation. The House bill would remove the limited exclusion, requiring all such unemployment compensation to be included in taxable income. The president's proposal would also remove the exclusions. This provision of the House bill would be effective in taxable years beginning after December 31, 1986.

Under current law, the portion of unemployment compensation excluded is the lesser of either one-half of the "excess" or the unemployment compensation benefits received. The "excess" is defined as the difference between the sum of adjusted gross income and unemployment compensation and the "base" amount. The base amount is $12,000 for an unmarried individual, $18,000 for a married couple filing jointly and zero for a married couple not filing a joint return.

Commentary: How Does the House Bill Compare with Other Proposals?

As the prior discussion notes, the House bill was not conceived in a vacuum; it is the culmination of years of exploration of possible changes.

The most striking fact is that, if one compares the original Treasury proposals with the latest House action, the favorable tax treatment of employer-provided welfare benefits has moved from total elimination (as in Treasury) to more moderate changes (in President Reagan's proposal), to almost total preservation in the latest House action. "Almost," for two reasons: (1) the bill contains major changes in the area of nondiscrimination rules for welfare benefits plans, which was a common concern of the administration proposals and (2) the future status of certain benefits remains uncertain. The limited 2-year extension of education assistance and group legal services suggests that the Ways and Means Committee intends to revisit at least that aspect of welfare benefits.

While it remains to be seen whether the Senate will have different ideas about the proper tax treatment of welfare benefits, the evolution over the past year clearly indicates that the employee benefits community has been able to flex its political muscle. The original Treasury proposal, which many believe was conceived without attention to the political ramifications, drew fire from a coalition of labor and management that exerted considerable pressure on the Reagan administration and on Congress.

The political considerations became paramount. On several occasions, House Ways and Means Chairman Dan Rostenkowski (D-IL) was explicit that the strong employee benefits lobby was influencing the willingness of committee members to recommend changes. December 8 on "This Week with David Brinkley," Rostenkowski was candid on this point.

[Fringe benefits] was the last item we negotiated, and . . . labor has been very forceful; I'm sure you're aware of how many people were outside the committee room. I can suggest to my committee members, but I have to pick up 19 votes on the committee to present a bill, and labor insisted that the benefits they bargained for should not be taxed, and that was the decision.

The House action on section 415 was clearly presented as a tradeoff for preservation of 401(k) plans.

Echoes of TEFRA and DEFRA

In one important area of retirement and capital accumulation plans, however, the House proposal is significantly more restrictive than either Treasury or President Reagan. The action taken to reduce and freeze temporarily the section 415 limits is more in line with the Senate and House tax-writing committees' actions in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and DEFRA. Reducing and freezing the 415 limits were also elements of one of the earliest tax reform proposals, the Bradley/Gephart bill. Such reductions advance-funded benefits of a growing segment of the work force, increasing the proportion of retirement income that will be provided on a pay-as-you-go unsecured basis by employers.

Tradeoffs Underscored

The House action on section 415 was clearly presented as a tradeoff for preservation of 401(k) plans. After several policy

reversals, the Reagan administration ended up recommending abolition of 401(k) plans to yield additional revenue that would make the bill "revenue neutral." The House preserved 401(k), with limits and further restrictions, but used the reduction in the section 415 limits to generate revenue to pay for retention of section 401(k).

In another important way, the House bill emphasizes a tradeoff to the corporate community. In the final hours of the bill's consideration in committee, Chairman Rostenkowski had decided not to tax health insurance but to tax group legal services, death benefits and premiums for group term life. Then Rep. Charles Rangel (D-NY) offered an amendment, which the committee accepted, to exempt all welfare benefits from taxation. To generate enough revenue to offset the Rangel Amendment, Rostenkowski proposed—and the committee agreed—to raise the top corporate tax rate by one percentage point, from 35 to 36 percent. This is an explicit legislative message to corporate America that to preserve tax preferences for welfare benefit plans, the price must be paid elsewhere.

The increase in the corporate tax rate is an explicit message to corporate America that to preserve tax preferences for welfare benefits, the price must be paid elsewhere.

Major Policy Change from Current Law

One difference from previous congressional proposals is that the House adopts the Reagan administration's recommendations for a major change in the tax treatment of preretirement lump-sum distributions. The abolition of 10-year forward income averaging and the imposition of an excise tax on distributions before age 59½ and on distributions not paid by age 70½ are major changes from current law, and are provisions in both the administration and House proposals. Another change in policy common to the administration and House proposals is the 10-percent excise tax on excess assets recouped by plan sponsors terminating defined benefit plans.

In the area of IRAs, however, the House bill is very different from the administration's. The bill backs off from the expansion of IRAs recommended by the administration. While the House is clearly not prepared to repeal IRAs, it may be having second thoughts about their usefulness in delivering retirement income. In fact, as the 401(k) and 403(b)/IRA offset is structured under the bill, it will encourage individuals considering both to put their money in a 401(k) or 403(b) plan rather than in an IRA, particularly where the employer provides a matching contribution. EBRI estimates that this could reduce IRA contributions by up to $8 billion in the first year.

Items Still Open

Other items in the bill suggest that even if both houses pass the bill, it would not end the debate over major issues. For example, the bill mandates that the Treasury Department study and report to Congress on the effects of present law on pension coverage tests, with recommendations on how those rules might be changed. The report is due by July 1, 1986, and its conclusions could influence the actions taken in the Senate and, if it gets to that point, the House/Senate conference committee. If the report is delivered too late for tax reform, it simply leaves further pension reform in the coverage area as an issue to be considered later, unless pension reform advocates in the Senate Finance Committee, such as Sens. Heinz and John Chafee (R-RI), decide that tax reform may be the appropriate vehicle to include broader pension reforms like vesting, integration and portability.

In his support for passage of the House bill, President Reagan made it clear that he would like a Senate bill closer to his original proposals.

What Will the Senate Do?

For the benefits community, it will not be easy to preserve the favorable treatment of welfare benefits contained in the House tax reform bill; it will be even more difficult to undo the package of restrictions imposed in the retirement and capital accumulation area.

In his support for passage of the House bill, President Reagan also made it clear that he would like a Senate tax reform bill that is closer to his original proposals. For employee benefits that could be ominous. As noted before, the Ways and Means Committee did far less than President Reagan and Treasury had requested. The administration can be expected to push the Senate back toward the administration position.

Senate Majority Leader Robert Dole (R-KS) said December 8 on NBC "Meet the Press:"

... I think we can do a lot better ... in the Senate. I think if it [the bill] comes to the Senate, we can improve it, we can make it again tax reform instead of sort of reshuffling the different loopholes and the different interest groups.
When asked: "Where else would you pick up revenue from what the House did?" Dole responded:

You don't need to pick up much more revenue. But I think you have to also take a look at some of the so-called fringe benefits that are not taxed in the House bill. You look at the health insurance fringe benefit, that's $24 billion a year. State and local taxes, $25 billion a year. You're not going to get all that, but you ought to be able to have some.

Dole was chairman of the Senate Finance Committee in 1982 and 1984, when the committee approved TEFRA and DEFRA, which have common approaches to the House tax reform bill. Dole continues to be a member of the Finance Committee and takes an active role in committee work.

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The Retirement Income Policy Act could be offered as a full or partial substitute for the relevant provisions in the House tax reform bill.

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Finance Committee Chairman Robert Packwood (R-OR) has stated publicly on numerous occasions that he is opposed to taxing employee benefits in general and that he would not support tax reform legislation that does.

With regard to health and welfare benefits, Packwood's support could mean that the favorable current law treatment, which is preserved in the House bill, could also be maintained in the Senate. Several Finance Committee members have in the past, however, advocated a tax cap on health insurance benefits (Sens. Dole and Durenberger (R-MO)), a more general cap on employee benefits (Sen. Durenberger) or limits on the exclusions for health and life insurance (Sen. Bradley).

The Senate Finance Committee, judging from its past actions, may be willing to make changes in the current-law treatment of retirement and capital accumulation programs. The Retirement Income Policy Act of 1985, sponsored by Sens. Heinz and Chafee, two Republican committee members, could be offered as a full or partial substitute for the relevant provisions in the House tax reform bill.

Some commentators expect the Senate Finance Committee in its consideration of tax reform to look closely at the possibility of including a new business transfer tax along the lines proposed by Finance Committee member Sen. Roth (S. 1102), as a way of lowering marginal tax rates. Each business would sum its total receipts and subtract from that total purchases, including physical capital and raw materials. The remainder, the firm's net receipts, would be the tax base and would be taxable at a 5-percent rate. This tax liability would then be credited against the firm's Social Security (FICA) liability and all credited amounts transferred to the Social Security trust funds. Roth calculates that at the 5-percent rate, which is itself subject to review, the proposal would generate a net $20 billion (i.e., over and above the FICA credit), which could be used to lower marginal tax rates.

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Some commentators expect the Finance Committee to look closely at the possibility of a new business transfer tax.

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Alternatively, the Senate may move in the direction of a bigger minimum tax on firms and individuals to gain revenue, allowing many current tax provisions to be maintained.

Pundits see 1986 as a complex and difficult year. The new Gramm-Rudman balanced budget measure will add to the confusion, as Congress seeks to deal with a full plate of tax and spending issues. Employee benefits will be at the center of this process, which will extend many years into the future. The presidency of Ronald Reagan to date makes it clear that a new tax law, whether reformed or simply revised, in 1986 is a very real possibility.
### Estimated Revenue Effects of H.R. 3838

**Pensions and Deferred Compensation, Fringe Benefits and ESOPs;**

*as Reported by the House Ways and Means Committee, FY 1986-1990*

(millions)

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<td>Modify cash and deferred arrangements $7,000 cap:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>551</td>
<td>1,008</td>
<td>966</td>
<td>1,115</td>
<td>1,304</td>
<td>4,944</td>
</tr>
<tr>
<td>Reduce section 415 limits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>117</td>
<td>323</td>
<td>357</td>
<td>408</td>
<td>468</td>
<td>1,673</td>
</tr>
<tr>
<td>Uniform distribution requirements:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excise</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Replace 10-year averaging with limited 3-year averaging:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>27</td>
<td>52</td>
<td>97</td>
<td>157</td>
<td>223</td>
<td>556</td>
</tr>
<tr>
<td>Repeal 3-year basis recovery rule for contributory plans:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Individual</td>
<td>134</td>
<td>813</td>
<td>1,869</td>
<td>2,363</td>
<td>2,365</td>
<td>7,544</td>
</tr>
<tr>
<td>Tax on preretirement distributions, uniform basis recovery rules:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>120</td>
<td>125</td>
<td>251</td>
<td>587</td>
<td>985</td>
<td>2,068</td>
</tr>
<tr>
<td>Adjustments to section 404 limitations:</td>
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<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>18</td>
<td>48</td>
<td>51</td>
<td>56</td>
<td>62</td>
<td>235</td>
</tr>
<tr>
<td>Excise</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Tax on qualified plan reversions:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excise</td>
<td>20</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>30</td>
<td>140</td>
</tr>
<tr>
<td>Tax on excess retirement distribution:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Excise</td>
<td>26</td>
<td>28</td>
<td>30</td>
<td>32</td>
<td>32</td>
<td>116</td>
</tr>
<tr>
<td>Loan provision:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>1</td>
<td>3</td>
<td>6</td>
<td>7</td>
<td>11</td>
<td>28</td>
</tr>
<tr>
<td>Repeal exclusion of current annuity income of corporations:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>3</td>
<td>15</td>
<td>34</td>
<td>54</td>
<td>73</td>
<td>179</td>
</tr>
<tr>
<td>Two-year extension of the exclusion for group legal plans:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
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<td></td>
<td></td>
</tr>
<tr>
<td>Two-year extension of the exclusion for education assistance:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Discrimination rules for employee benefits:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
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</tr>
<tr>
<td>ESOP provisions:</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Individual</td>
<td>1,062</td>
<td>2,117</td>
<td>1,371</td>
<td>686</td>
<td>522</td>
<td>5,758</td>
</tr>
<tr>
<td>Corporate</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td><strong>Subtotal, Pensions; Fringe Benefits; ESOPs:</strong></td>
<td>851</td>
<td>2,262</td>
<td>3,662</td>
<td>4,851</td>
<td>5,594</td>
<td>17,220</td>
</tr>
<tr>
<td>Individual</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Corporate</td>
<td>1,065</td>
<td>2,132</td>
<td>1,405</td>
<td>740</td>
<td>595</td>
<td>5,937</td>
</tr>
<tr>
<td>Excise</td>
<td>20</td>
<td>56</td>
<td>58</td>
<td>60</td>
<td>62</td>
<td>256</td>
</tr>
<tr>
<td><strong>Total</strong></td>
<td>1,936</td>
<td>4,450</td>
<td>5,125</td>
<td>5,651</td>
<td>6,251</td>
<td>23,413</td>
</tr>
</tbody>
</table>


1Gain of less than $5 million.
2Loss of less than $5 million.
3Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.
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Nothing herein is to be construed as necessarily reflecting the views of the Employee Benefit Research Institute or as an attempt to aid or hinder the passage of any bill pending before Congress.
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<tr>
<td>Ownership Plans</td>
<td>An ESOP trust must meet the general requirements concerning benefits, contributions and coverage that other pension and profit-sharing plans must meet to be qualified for tax exemption. In addition, tax-credit ESOPs must satisfy additional qualifications.</td>
<td>ESOPs would no longer function as qualified retirement plans. Instead plans would be capital accumulation plans. Employers could still establish trusts for employee stock ownership, but allocation of employer securities within the plan would be based on the first $50,000 (rather than the first $100,000) of compensation. The special financing incentives for ESOPs would be retained with some modifications.</td>
<td>Apply to all ESOPs: Additional nondiscrimination tests, 100 percent vesting in 10 years and 20 percent after 6 years of service, permit qualified participant to direct divestification of investments, independent appraisers to value employer securities, additional distribution rules, pass-thru of voting rights for nonregistration-type securities. Repeal special financing incentives provided in DEFRA.</td>
</tr>
<tr>
<td>VI. Unemployment Compensation</td>
<td>A portion of unemployment compensation equal to the difference between unemployment compensation plus adjusted gross income and a base amount defined according to marital status.</td>
<td>Requires all unemployment compensation to be included in gross income.</td>
<td>Same as president's proposal.</td>
</tr>
</tbody>
</table>

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Source: Employee Benefit Research Institute (H.R. 3838) and Joint Committee on Taxation (current law and president's proposal).

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## C. Benefits provided under a cafeteria plan

Under a cafeteria plan, an employee is offered a choice between cash and one or more fringe benefits. If certain requirements are met, then the mere availability of cash or certain permitted taxable benefits under a cafeteria plan does not cause an employee to be treated as having received the available cash or taxable benefits for income tax purposes.

A highly compensated employee is treated as having received available cash and taxable benefits if the cafeteria plan discriminates in favor of highly compensated individuals as to eligibility or as to benefits and contributions. In addition, if more than 25 percent of the total excludable benefits for a plan year are provided to key employees (certain officers and owners), then the key employees will be taxed as though they received all available taxable benefits under the plan.

### Present Law

- Apply a special rule to reimbursements of medical, legal, or dependent care expenses under a reimbursement account, under which the reimbursements would be deemed to be nondiscriminatory if the average reimbursements for highly compensated employees do not exceed 125 percent of the average reimbursements for all other participants in the cafeteria plan. In addition, the contributions provided to the top 20 highly compensated employees could not exceed 25 percent of the total contributions under the plan for any year. Under the proposal, reimbursement of insurance premiums would not be permitted from a reimbursement account.

### President's Proposal

- Cafeteria plans subject to eligibility test applicable to statutory fringe benefits. All benefits available to highly compensated employees are to be available to all other employees on the same terms and conditions. No more than 25 percent of the benefits under the plan may be provided to key employees.

### H.R. 3838

- Effective date—Effective for plan years beginning after December 31, 1985.

## V. Employee Stock

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<tr>
<td></td>
<td>benefits provided to highly compensated employees would not be eligible for tax exclusion. The amount to be included in gross income in the case of insurance-type benefits would be the value of the coverage provided to a highly compensated employee and not reimbursements received under the plan for expenses.</td>
<td>criminatory plan would be included in their income.</td>
<td></td>
</tr>
<tr>
<td>Welfare benefit plans. The nondiscrimination rules would also apply to benefits provided under a tax-exempt voluntary employees' beneficiary association, supplemental unemployment compensation benefit trust or group legal services organizations.</td>
<td>Same as president's proposal.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Effective dates. The provisions relating to uniform nondiscrimination rules generally would be effective for plan years beginning after December 31, 1985, except that, in the case of a health plan, the proposal would be effective for plan years beginning after December 31, 1986. The proposal would provide a delayed effective date for collectively bar-</td>
<td>Effective date. Plan years beginning after December 31, 1986.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>ITEM</td>
<td>PRESENT LAW</td>
<td>PRESIDENT'S PROPOSAL</td>
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<td>Certain mechanical adjustments would be made to the top 10-percent and 3 highest-paid employees tests to take into account an employer's salary structure.</td>
<td>Excludable employees. Certain classes of employees would be disregarded in applying the 125-percent test. Thus, under the proposal, the following employees need not be taken into account in testing whether a plan provides nondiscriminatory coverage:</td>
</tr>
<tr>
<td>Excludable employees. Employees who are covered by a collective bargaining agreement are excluded from consideration in applying the nondiscrimination rules as long as the benefits provided by the plan or program are the subject of good faith bargaining. The eligibility rules for self-insured medical reimbursement plans also provide that employees need not be taken into account if they have not completed three years of service, have not attained age 25, or are part-time or seasonal employees.</td>
<td>Excludable employees. The following employees may be excluded in applying the 90 percent eligibility test:</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td>(1) if the plan so provides, employees with less than one year of service (30 or 90 days, in case of an employer-maintained health plan), (2) if the plan so provides, part-time and seasonal employees, (3) employees covered by certain collective bargaining agreements, and (4) nonresident aliens who have no U.S. earned income.</td>
<td>(1) employees who have not completed 180 days of service, (2) employees who normally work less than 20 hours a week, (3) employees who normally work less than 1,000 hours a year, (4) employees under age 21. (5) employees covered by certain collective bargaining agreements, and (6) nonresident aliens who have no U.S. earned income.</td>
</tr>
</tbody>
</table>

Sanctions for discrimination. If a plan is found to be discriminatory in coverage, benefits or utilization the
butions provided under the plan for any year. This rule would apply to each fringe benefit otherwise excludable from gross income.

**Highly compensated employees.** Present law does not explicitly define the group of employees who are officers, shareholders or highly compensated.

**Highly compensated employees.** Provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the 3-year period ending on the last day of the plan year, the employee:

1. owns an interest of at least 1 percent of the employer (determined with attribution rules);
2. earns at least $50,000 in annual compensation from the employer;
3. earns at least $20,000 in compensation from the employer and is among (a) the top ten percent of employees by compensation, or (b) the top three employees by compensation; or
4. is a family member of another highly compensated employee for such year.

**Same as president's proposal with the following changes:** An employee is considered highly compensated if during the current plan year or either of the 2 preceding plan years, the employee:

1. is a 5-percent owner;
2. earns over $50,000 in annual compensation;
3. earns at least $20,000 and is among top 10 percent of employees on the basis of compensation. If employee earns less than $35,000 and is not in top 5 percent of all employees, employee is not included in top-paid group.
<table>
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<td></td>
<td>er. Certain benefits would be permitted to vary by compensation level. Noninsurance-type benefits. Employee educational assistance, miscellaneous fringe benefits and qualified tuition reductions would also be subject to a nondiscriminatory benefits test under which the average amount of benefits provided to highly compensated employees could not exceed 125 percent of the average amount of benefits to other employees. In the case of educational assistance benefits, only amounts expended for degree programs would be required to be tested under this nondiscrimination rules. Noninsurance-type benefits. For dependent care assistance and educational assistance plans, benefits available to any highly compensated employee must be available on the same terms and conditions to all other employees eligible to participate. The average benefit provided on behalf of non-highly compensated employees must be equal to or exceed 80 percent of the average benefit provided to highly compensated employees.</td>
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</tr>
<tr>
<td>Concentration test. An exclusion is not available unless the following concentration tests are satisfied: (1) in the case of dependent care assistance or prepaid legal services, no more than 25 percent of the amounts contributed for a plan year are provided to five-percent owners (or their spouses or dependents); or (2) in the case of educational assistance, no more than 5 percent of the amounts paid or incurred by the employer during a plan year are provided to 5-percent owners (or their spouses or dependents). Concentration test. Modify the utilization test of present law applicable to group legal services, employee educational assistance, and dependent care assistance. Under the modification, the contributions provided to the top 20 highly compensated employees by compensation could not exceed 25 percent of the total contri-</td>
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<td>program is required to meet the eligibility requirement by covering a reasonable classification of employees in a manner determined by the IRS not to result in prohibited discrimination. A self-insured medical reimbursement plan or group-term life insurance plan may also satisfy the requirement by covering a stated percentage of the employer's employees.</td>
<td>only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time.</td>
<td>participate in the plan.</td>
</tr>
<tr>
<td></td>
<td>Aggregation rules. In applying the nondiscrimination tests to certain statutory fringe benefits, all employees of employers that are under common control are aggregated and treated as if employed by a single employer.</td>
<td>Nondiscriminatory availability. All types and levels of benefits available to any highly compensated participant must also be available to all non-highly compensated participants. Similarly, any condition for receipt of a benefit would be required to be applied in a nondiscriminatory manner.</td>
<td>The eligibility requirement may not discriminate in favor of highly compensated employees.</td>
</tr>
<tr>
<td></td>
<td>Insurance-type benefits. Apply a nondiscriminatory benefits test to group-term life insurance, health benefits, and group legal services benefits provided under a permanent and enforceable plan. This test would apply whether or not the benefit was provided through insurance or self-insured by an employer.</td>
<td>Insurance-type benefits. For accident and health plans, a plan is discriminatory if more than 25 percent of employees benefiting from the plan are highly compensated and less than 75 percent of employees eligible to participate actually benefit from the plan.</td>
<td></td>
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<tr>
<td><strong>B. Nondiscrimination Requirements</strong></td>
<td>In general. Under present law, exclusions for most of the statutory fringe benefits are conditioned on compliance with various rules prohibiting discrimination for benefits provided by an employer under an insured health plan or for death benefits.</td>
<td><strong>Employee educational assistance and group legal services.</strong> The exclusion for employee educational assistance and group legal services plans would be available only to the extent that employer contributions to the plan are fixed before the beginning of the year for which benefits are provided. Also, the annual cap on the educational assistance exclusion of $5,000 during a year for an employee would be repealed.</td>
<td><strong>Effective date.</strong> Generally effective for taxable years beginning after 1985.</td>
</tr>
<tr>
<td></td>
<td>These nondiscrimination rules generally prohibit discrimination as to eligibility to participate. A plan or pro-</td>
<td><strong>In general.</strong> Establish uniform nondiscrimination rules applicable to employer-provided group-term life insurance, accident and health plans (whether or not insured), group legal services, employee educational assistance, dependent care assistance, cafeteria plans, miscellaneous fringe benefits qualified tuition reductions, and welfare benefit funds.</td>
<td><strong>Establish comprehensive nondiscrimination rules.</strong> Three general rules: (1) eligibility rule for all statutory fringe benefits, (2) benefits test applicable to insurance-type statutory benefit plans and (3) benefits test applicable to all other statutory benefit plans.</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Nondiscriminatory coverage.</strong> Provide that the tax exclusion would be available</td>
<td><strong>Nondiscriminatory coverage.</strong> At least 90 percent of all employees must be eligible to</td>
</tr>
<tr>
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<tr>
<td></td>
<td>plan termination generally may be paid to the employer after plan benefits, accrued to the date of the plan termination, have been provided. Assets reverted to the employer are includible in the employer's gross income.</td>
<td>suant to a plan termination occurring after December 31, 1985.</td>
<td></td>
</tr>
</tbody>
</table>

IV. Treatment of Nonwage Compensation

A. Welfare Benefit Tax Exclusions

Present law provides specific income tax and employment tax exclusions with respect to the following benefits provided by an employer to employees:

- (a) the cost of up to $50,000 of group-term life insurance;
- (b) up to $5,000 of death benefits;
- (c) accident or health benefits;
- (d) benefits under prepaid legal services plans;
- (e) commuting through use of a van pool;
- (f) up to $5,000 annually of employee educational assistance; and
- (g) dependent care assistance.

Employer-provided health benefits. Employer contributions on behalf of an employee to a health plan would be partially includible in the employee's gross income. The amount included in income would be $10 a month for individual coverage and $25 a month for family coverage.

Repeal of exclusion for employer-provided death benefits. Repeal the $5,000 exclusion for employer-provided death benefits.

Expiration of van pooling exclusion. Allow the exclusion for employer-provided transportation (van pooling) to expire on December 31, 1985, as scheduled under present law.

Retain present law for life, death, accident and health benefits and day care plans. Extend present law for 2 years education and legal assistance. Impose $5,000 cap on employer-provided dependent care assistance.

Effective date. Taxable years after December 31, 1985.
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<td>either a profit-sharing or stock bonus plan for the same employer, then the employer's deduction for contributions for that year is generally limited to the greater of (i) the amount needed to satisfy the minimum funding requirement of the pension plan or (ii) 25 percent of the aggregate compensation of covered employees. This limit does not apply when an employee participates in both a defined benefit and a money purchase pension plan of the same employer.</td>
<td>Employer contributions in excess of the deduction limit may be carried over and deducted in later years. They are not subject to any tax.</td>
<td>Same as the president’s proposal.</td>
</tr>
<tr>
<td>4. Nondeductible contributions</td>
<td>Employer contributions in excess of the deductible limits would be subject to a 10 percent annual nondeductible excise tax until the excess is eliminated.</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5. Asset reversions under qualified plans</td>
<td>Prior to the satisfaction of all liabilities with respect to employees and beneficiaries, assets held under a qualified plan generally may not be used for, or diverted to, purposes other than the exclusive benefit of employees. However, assets remaining in the plan upon</td>
<td>A nondeductible excise tax equal to 10 percent of the plan funds reverting to the employer upon plan termination would be imposed.</td>
<td>Same as the president’s proposal.</td>
</tr>
<tr>
<td></td>
<td></td>
<td>Effective date. The 10 percent recapture tax would apply to qualified plan assets reverting to an employer pur-</td>
<td></td>
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</thead>
<tbody>
<tr>
<td>2. Defined benefit plans</td>
<td>Employers may deduct pension liabilities as long as the plan meets minimum standards. In calculating the minimum funding requirement and deduction limits, employers are required to use actuarial assumptions that are reasonable in the aggregate.</td>
<td>No proposal.</td>
<td>Require that certain actuarial assumptions that have a material effect on the measurement of liabilities (e.g., interest rate and marital status) be reasonable, standing alone. Penalty imposed on overstatement of pension liabilities.</td>
</tr>
<tr>
<td>3. Combination of pension and other plans</td>
<td>Employer contributions to a money purchase pension plan are generally deductible under rules applying to defined benefit pension plans. The amount required under the minimum funding standard is the contribution rate specified by the plan, which cannot exceed 25 percent of a participant's compensation. If an employer maintains a pension plan (defined benefit or money purchase) and</td>
<td>Extend the 25-percent of aggregate compensation limit to all combinations of defined benefit and defined contribution plans.</td>
<td>Same as the president's proposal.</td>
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<td>ITEM</td>
<td>PRESENT LAW</td>
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<tr>
<td>B. Deductions for contributions to qualified plans</td>
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<td>postretirement cost-of-living increases.</td>
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<tr>
<td>1. Profit-sharing and stock bonus plans</td>
<td>Employer contributions for a year not in excess of 15 percent of the aggregate compensation of covered employees are generally deductible for the year paid. Employer contributions in excess of the deduction limits may be carried over and deducted in later years.</td>
<td>The proposal would modify the 15 percent of compensation limit to apply on an individual, rather than an aggregate, basis. Thus, the deductible contribution with respect to a particular employee could not exceed 15 percent of that employee's compensation. The present-law carry-forward for unused deduction limits would be repealed except under certain &quot;retirement type&quot; profit-sharing plans. A profit-sharing plan would be treated as a &quot;retirement type&quot; plan with respect to an individual if: (1) the individual is an active participant in the plan; (2) the individual is not a participant in any other profit-sharing or stock-bonus plan maintained by the employer; (3) contributions are based on a formula using a reasonable</td>
<td>Maintain the 15 percent of aggregate compensation deduction limit. In the case of a profit-sharing or stock bonus plan integrated with Social Security reduce this limit by the employer share of Social Security taxes taken into account under the plan. The limit carry-forward for all profit sharing and stock bonus plans (including retirement type plans) would be repealed. Effective, for plan years after December 31, 1985. Special transitions rules apply to unused pre-1986 limit carry forwards.</td>
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<td>applicable separate plan percentage limits. In the case of a plan that is not super top-heavy, the lower combined plan limit does not apply if certain requirements are met.</td>
<td>10 percent of the excess would be imposed. Under the proposal, the dollar amount would be 1.25 times the defined benefit dollar limit (i.e., 1.25 times $90,000 would equal $112,500 for 1985 through 1987).</td>
<td>$112,500 = $562,500 in 1986).</td>
</tr>
</tbody>
</table>

4. Cost-of-living adjustments

Defined contribution and defined benefit limits are frozen at current levels until 1988.

No adjustments for inflation.

The defined benefit plan dollar limit would be indexed beginning in 1988 to reflect post-1986 cost of living increases. No adjustments would be made to the defined contribution plan limit until the limit equals 25 percent of the defined benefit plan limit. Thereafter, the defined contribution plan limit would be increased to the extent necessary to maintain the limit equal to 25 percent of the defined benefit plan limit.

Employees would be permitted to make additional contributions to a qualified cost-of-living account under a pension plan, to provide...
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<td>This limit is proportionately reduced for participants with less than 10 years of service.</td>
<td>1993.</td>
<td>The limit would be actuarially reduced, as under current law, for benefits commencing before age 62, but the dollar limit for benefits commencing at or after age 55 generally would not be reduced to an amount less than $65,000 (for police and firefighters, $50,000, regardless of age). For airline pilots the dollar limit on benefits would be reduced only if benefits commenced prior to age 60.</td>
</tr>
</tbody>
</table>

3. Combined plan limit

The combined plan limit for an individual who participates in both a defined contribution plan and a defined benefit plan of the same employer is equal to the lesser of (i) 125 percent of the separate plan dollar limits or (ii) 140 percent of the separate plan percentage limits.

A lower combined plan limit applies for individuals participating in a top-heavy plan. The limit is the lesser of (i) 100 percent of the otherwise applicable separate plan dollar limits, or (ii) 140 percent of the otherwise applicable separate plan percentage limits.

The combined plan limit for individuals who participate in both a defined contribution plan and a defined benefit plan of the same employer would be repealed for all nontop-heavy plans.

Retains current law limits.

An additional excise tax would be imposed on all participants receiving annual benefits in excess of a specified amount. To the extent that aggregate annual distributions made with respect to any individual from qualified plans, IRAs and tax-sheltered annuities exceed that dollar amount, an excise tax equal to

\[ 0.15 \times (\text{excess benefits}) \]

would be imposed on the excess.

A 15 percent excise tax would be imposed on aggregate annual distributions from all tax-favored retirement arrangements in excess of the greater of $112,500 or 1.25 times the defined benefit dollar limit. For the years in which an individual receives a lump-sum distribution and elects 5-year averaging and/or capital gains treatment, the base would be the lesser of (1) the amount of the lump sum taxed under the averaging rules or treated as capital gains or (2) 5 times the base that otherwise would be in effect for the year.
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<td>III. Tax Deferral Under Qualified Plans</td>
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<td>A. Overall limits on contributions and benefits</td>
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<tr>
<td>1. Defined contribution plans</td>
<td>Annual additions on behalf of a participant under a qualified defined contribution plan are limited to the lesser of (i) 25 percent of compensation, or (ii) $30,000.</td>
<td>One half of all employees contributions would be treated as annual additions.</td>
<td>Annual additions reduced to $25,000, and all employee contributions would be treated as annual additions.</td>
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<td>Annual additions include employer contributions, forfeitures and if employee contributions exceed 6 percent of compensation, the lesser of (i) one-half the employee contributions, or (ii) total employee contributions in excess of 6 percent of compensation.</td>
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<tr>
<td>2. Defined benefit plans</td>
<td>Annual benefits payable on behalf of a participant from a qualified defined benefit plan are limited to the lesser of (i) 100 percent of compensation or (ii) $90,000.</td>
<td>The overall limit would be reduced for participants with less than 10 years of plan participation. This would be phased in, becoming fully effective for years after December 31,</td>
<td>Annual benefits payable would be reduced to $77,000. The dollar limit would be reduced proportionately (as in the president's proposal) for participant's with less than 10 years of participation.</td>
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<td>that the loan, when added to the outstanding balance of all other plan loans, does not exceed the lesser of (1) $50,000, or (2) the greater of $10,000 or one-half the participant's accrued benefit.</td>
<td>outstanding loan balance during the prior 12 months or (2) the greater of $10,000 or one-half of the employee's accrued benefit.</td>
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<td>2. Repayment period</td>
<td>The exception applies if the loan must be repaid within 5 years, or within a reasonable period if the loan is used to acquire or improve a personal residence of the participant or family member.</td>
<td>The proposal provides an exception to the 5-year repayment period only for those loans applied to the first-time purchase of the participant's principal residence.</td>
<td>The exception to the 5-year repayment period is limited to the purchase of the participant's principal residence. Repayment must be amortized in level payments, paid at least quarterly over the term of the loan.</td>
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<tr>
<td>3. Interest paid on plan loans</td>
<td>Interest paid on a loan from a qualified plan is deductible.</td>
<td>No provision.</td>
<td>Defer the deduction for interest paid by (1) all employees with respect to loans secured by elective deferrals under a qualified cash or deferred arrangement or tax-sheltered annuity and (2) key employees with respect to loans from any qualified plan, by denying a deduction for the interest and increasing a participant's basis under the plan by the amount of nondeductible interest paid.</td>
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Effective date. The modifi-
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<td>sidered a return of employee contributions until the individual's basis has been recovered.</td>
<td>Effective dates. The provisions generally would apply to distributions made after December 31, 1985.</td>
<td>Effective dates. Generally the same as president's proposal, except that the reordering of the basis recovery rules applicable to distributions before the annuity starting date would not apply to employee contributions made prior to January 1, 1986. The repeal of the 3-year basis recovery rule would apply to an individual whose annuity starting date is after July 1, 1986.</td>
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</table>

C. Loans under qualified plans

1. Amounts treated as distributions

| Subject to certain exceptions, a loan to a participant from a qualified plan is treated as a taxable distribution of plan benefits. An exception is provided to the extent | A loan would be treated as a nontaxable distribution to the extent that the loan (when added to an outstanding balance) does not exceed the lesser of (1)$50,000, reduced by the highest | Same as the president's proposal. |

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changed.
In addition, to the extent any distribution consists of employer securities attributable to employee contributions, recognition of the net unrealized appreciation is deferred until the securities are sold or exchanged.

e. Basis recovery

Distributions prior to the annuity starting date are treated as being made first out of nontaxable employee contributions and then out of taxable amounts (employer contributions and income).

Distributions after the annuity starting date are treated under the following rules:

(1) In general, each payment is treated as part of a payment of income and part a recovery of employee contributions.

(2) Under a special rule, if an individual will receive all employee contributions within the first 3 years after the annuity starting date, then all distributions are con-
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<td>c. Pre-1974 capital gains treatment</td>
<td>A participant may elect to treat the pre-1974 portion of any lump-sum distribution as long-term capital gains.</td>
<td>Repeal the special pre-1974 capital gains treatment.</td>
<td>in 1985 and to claim 10-year averaging.</td>
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<tr>
<td>d. Net unrealized appreciation</td>
<td>If an employee receives a lump-sum distribution of employer securities, only an amount equal to the plan's basis in the securities is currently includible in income. Recognition of the net unrealized appreciation is deferred until the securities are sold or ex-</td>
<td>Repeal current law.</td>
<td>Maintain current law.</td>
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<td>distributions</td>
<td>Under certain circumstances, distributions from a qualified plan may be rolled over tax-free to another qualified plan or IRA. Special rules govern the extent to which distributions from particular plans may be rolled over, as well the types of plans to which rollovers may be made.</td>
<td>Permit all distributions (other than required minimum distributions) to be rolled over to other tax-favored retirement arrangements.</td>
<td>Retain present-law rollover restrictions.</td>
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<td>a. Rollovers</td>
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<td>10-year forward income averaging</td>
<td>Certain lump-sum distributions received from a qualified plan may qualify for special 10-year forward averaging treatment.</td>
<td>Repeal the special 10-year forward averaging treatment.</td>
<td>Repeals 10-year forward averaging. For individuals age 59 1/2 and over, one lifetime use of forward income averaging would be permitted, with the averaging period reduced to 5 years. For individuals who attain age 50 by January 1, 1986, one election on distribution received prior to age 59 1/2 to use 5-year averaging allowed. Generally effective for distributions received after December 31, 1985. A transition rule would apply for individuals who separate from service in December 1985 and receive the lump-sum in January 1986 to treat the distribution as received</td>
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<td>to 5-percent owners who have not attained age 59 1/2, unless the early withdrawal is made on account of the employee's disability or death. A similar tax also applies to early withdrawals made from an IRA.</td>
<td>rules for IRAs. Increase the additional tax to 20 percent unless the distribution is made in the form of a qualifying annuity. The tax would be reduced to 10 percent if the distribution is made on account of (1) the purchase of the individual's first principal residence, (2) the payment of college expenses for a dependent of the individual or (3) unemployment during the period following the cessation of unemployment benefits.</td>
<td>for IRAs). An exception is provided for any distribution that is part of a scheduled series of level payments under an annuity for the life of the participant (or the joint lives of the owner and the owner's beneficiary).</td>
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</table>

Qualifying annuity. A qualifying annuity would be an annuity commencing after the participant attains age 50, payable as one of a scheduled series of substantially non-increasing payments under (1) an annuity for the life of the participant or the joint lives of the participant and the participant's beneficiary), or (2) an annuity for a term certain of at least 180 months commencing upon retirement under the plan. |

2. Lump-sum
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<td>benefits must commence no later than April 1 of the calendar year following the calendar year in which the participant (1) attains age 70 1/2 or (2) with respect to participants who are not 5-percent owners, the taxable year in which the participant retires, if later.</td>
<td>cations would be made to those rules.</td>
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<td>Distributions from an IRA are required to commence no later than April 1 of the calendar year following the calendar year in which the owner attains age 70 1/2.</td>
<td>The 50 percent excise tax applicable to IRAs would apply to all tax-favored plans. The recipient of the distribution would be primarily liable with a right, where appropriate, to recover the tax from the plan. The current disqualification sanction would be eliminated.</td>
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<td></td>
<td>A qualified plan failing to satisfy the minimum distribution rules may be disqualified. A 50-percent excise tax applies to amounts required to be distributed from an IRA that are not distributed.</td>
<td>Effective date. Distributions made after December 31, 1985.</td>
<td>Effective date. Same as president's proposal plus employees who are not 5%-owners and who have attained age 70 1/2 by January 1, 1988, may defer benefit payment until retirement.</td>
</tr>
<tr>
<td>b. Withdrawals before age 59 1/2</td>
<td>A 10-percent additional income tax is imposed on certain early withdrawals from qualified plans with respect</td>
<td>Conform the early withdrawal rules for qualified plans and tax sheltered annuities to the</td>
<td>A 15 percent excise tax would apply to withdrawals before death, disability or attainment of age 59 1/2 (same as</td>
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<td>benefit plans do not apply to top-heavy plans. Top heavy plans must satisfy one of 3 alternate benefit accrual rates.</td>
<td>Permit forfeitures in a money purchase pension plan to be reallocated to remaining participants.</td>
<td>rule would be applied. Same as president's proposal.</td>
</tr>
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</table>

4. Benefit forfeitures
Forfeitures in a money purchase pension plan may not be reallocated to remaining participants, but must be used to reduce future employer contributions or to offset plan administrative expenses.

B. Withdrawal of benefits

1. Uniform minimum distribution rules

a. Withdrawals after age 59 1/2
Tax-favored retirement arrangements are subject to certain minimum requirements concerning the timing and amount of before-death and after-death distributions. Under these rules, distribution of a participant's...

Retain the present law rules relating to benefit commencement date and subject all qualified plans, tax-sheltered annuities and IRAs to uniform minimum distribution rules. Certain simplifying modifi-

Effective date. Plan years ending after December 31, 1985. Same as president's proposal plus employees who are not 5 percent owners and who have attained age 70 1/2 by January 1, 1988 may defer commencement of benefit payments until retirement.
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<td>retirement benefits were the subject of good faith bargaining. Certain non-resident aliens and certain airline pilots also are disregarded.</td>
<td></td>
<td>No Provision.</td>
<td>Social Security benefits earned with a prior employer would not be considered in testing whether a defined benefit plan is considered discriminatory.</td>
</tr>
<tr>
<td>2. Nondiscrimination rules for defined benefit plans</td>
<td>Under present law, a plan is not qualified unless contributions and benefits do not discriminate in favor of employees who are officers shareholders or highly compensated. A plan is not considered discriminatory merely under the plan bear a uniform relationship to compensation. For purposes of determining whether benefits bear a uniform relationship to compensation, the employer-provided share of an employee's Social Security benefit may be taken into account. Under certain circumstances, the employer-provided share of Social Security benefits may be taken into account more than once under a defined benefit pension plan because an employer may reduce plan benefits by Social Security benefits earned with a prior employer.</td>
<td></td>
<td>Effective date. Plan years after December 31, 1986.</td>
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<tr>
<td>3. Top-heavy plans</td>
<td>Under present law, the benefit accrual rules generally applicable to qualified defined plans are the same as those that apply to non-qualified defined contribution plans.</td>
<td>No provision.</td>
<td>In determining whether a plan is top heavy, the fractional benefit accrual rules generally applicable to qualified defined plans are the same as those that apply to non-qualified defined contribution plans.</td>
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<td>three employees by compensation; or (4) is a family member of another highly compensated employee for such year.</td>
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<td>Certain mechanical adjustments would be made to the top 10-percent and 3 highest-paid employees tests to take into account an employer's salary structure. Similarly, adjustments would be provided to the three-year lookback rule to reflect significant fluctuations in an employer's work force.</td>
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<td>Excludable employees. In applying the percentage test, certain employees who have not (1) completed minimum periods of service (generally 1 year) and (2) attained age 21 may be disregarded. Employees with less than 3 years of service may be excluded if the plan provides for full and immediate vesting. In addition, in applying both the percentage test and the classification test, employees not covered by the plan who are included in a unit of employees covered by a collective bargaining agreement are disregarded.</td>
<td>Excludable employees. Narrow the class of employees who could be excluded from consideration in applying the percentage test by repealing the exceptions for employees with less than 3 years of service and for certain airline pilots.</td>
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<td>Effective date. Effective for plan years beginning after December 31, 1986. For collectively bargained plans, the proposal would not apply to plan years beginning before the termination of the current collective bargaining agreement.</td>
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<td>of the Treasury determines that it covers a classification of employees that is found not to discriminate in favor of employees who are officers, shareholders or highly compensated.</td>
<td>Aggregation rules.</td>
<td>Retain present law.</td>
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<td><strong>Aggregation rules.</strong> In applying both the percentage and classification tests, all employees of employers that are under common control are aggregated and treated as if employed by a single employer.</td>
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<td><strong>Highly compensated employees.</strong> Present law does not explicitly define the group of employees who are officers, shareholders or highly compensated.</td>
<td><strong>Highly compensated employees.</strong> Provide a uniform definition of highly compensated employees. An employee would be treated as highly compensated for a plan year if, at any time during the three-year period ending on the last day of the plan year, the employee-- (1) owns an interest of at least 1 percent of the employer (determined with attribution rules); (2) earns at least $50,000 in annual compensation from the employer; (3) earns at least $20,000 in compensation and is among (a) the top 10 percent of employees by compensation or (b) the top</td>
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### A. Nondiscrimination rules

1. Coverage requirements for qualified plans

The coverage rules for qualified plans require that a plan cover employees in general rather than merely employees who are officers, shareholders or highly compensated. A plan generally satisfies the coverage rules if it meets either (1) a percentage test or (2) a classification test.

**Percentage test.** A plan meets the percentage test if (1) it benefits at least 70 percent of all employees or (2) it benefits at least 80 percent of the employees eligible to benefit under the plan, and at least 70 percent of all employees are eligible (i.e., the plan benefits at least 56 percent of all employees).

**Classification test.** A plan meets the classification test if the Secretary

**Percentage test.** The coverage test would be met only if the percentage of highly compensated employees eligible to receive benefits does not exceed 125 percent of the percentage of all other employees receiving benefits. Under certain very limited circumstances in the case of a compelling business reason (such as a merger), the IRS could waive the 125 percent test in favor of a more liberal test for a period of time.

**Classification test.** Repeal present law.

 Treasury Department to conduct a study on the effect of the present law coverage tests, with recommendations on changes submitted to Congress no later than July 1, 1986.
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<td>icyholder receives any amount under an annuity contract before reaching age 59 1/2, an additional income tax is imposed equal to 5 percent of the amount included in income. This penalty does not apply if the distribution is one of a series of periodic payments lasting at least 60 months or is made for certain other purposes.</td>
<td>investment in the contract during the taxable year. The owner of a deferred variable annuity contract would be treated as owning a pro rata share of the assets and income of the separate account underlying the variable contract. As a result, the owner would not be taxed on the unrealized appreciation of assets underlying a variable contract. Effective date. The proposal would become effective for investment income credited after December 31, 1985, to policies issued on or after the date of committee action.</td>
<td>deferred annuity contract over the contract's basis during the taxable year. The owner of a deferred variable annuity contract would be treated as owning a pro rata share of the assets and income of any separate account underlying the variable contract. As a result, the owner would not be taxed on the unrealized appreciation of assets underlying a variable contract. Effective date. The 15-percent excise tax applicable to qualified plans would apply on early withdrawals, except in the case of substantially equal periodic payments over the life of the owner or lives of the owner and a beneficiary. When the annuity is held by a person other than a natural person (such as a corporation), no additional income tax imposed. Effective date. Effective for contributions or withdrawals after December 31, 1985.</td>
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II. Minimum Standards for Qualified Plans

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<td>the year in which the employee attains normal retirement age, or (2) the year in which the employee separates from service. The total benefits scheduled to be paid to the participant must be more than 50 percent of the maximum amount that could have been paid to the participant if no provision were made for payments to the beneficiary.</td>
<td>over the lifetime of the participant are at least 66 2/3 percent of the total benefits payable with respect to the participant, (2) in the case of benefits payable over a period of more than 1 year, to be paid on a substantially non-increasing basis, and (3) after the death of the employee, to provide for the commencement of benefits to the employee's beneficiary within 1 year after the employee's death.</td>
<td>In addition, benefits would not be treated as made available merely because an employee is allowed to elect to receive a lump sum payable within 60 days of the election. This rule applies only if the employee's total deferred benefit does not exceed $3,500 and the employee is no longer entitled to elect deferrals under the plan.</td>
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E. Deferred annuity contracts

Interest credited to the cash surrender value of a deferred annuity is not taxed currently, but is taxed when paid to the policyholder. If a policyholder elects to receive the cash value over a period of more than 1 year, the income tax on the cash value is deferred over the period of the election. The owner of a deferred annuity contract would include in income any increase in the excess of the contract's cash value over the owner's investment in the contract. A nonindividual owner of a deferred annuity contract would include in income any increase in the cash surrender value of the contract.
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<td>tax-exempt employers (section 457 plans)</td>
<td>Under an eligible deferred compensation plan maintained by a state or local government or rural electric cooperative, an employee may elect annual deferrals equal to the lesser of $7,500 or 33-1/3 percent of compensation (net of the deferral). A participant in an eligible plan who elects to defer the receipt of current compensation will be taxed on the deferral amounts (and income attributable thereto) when such amounts are paid or otherwise made available. If an unfunded State or local plan (other than certain judicial plans) does not qualify as an eligible plan, the deferral is included in the employee's gross income when there is no longer a substantial risk of forfeiture of such amount.</td>
<td>Tax-exempt and public employers eligible to maintain section 457 plans.</td>
<td>Same as president's proposal.</td>
</tr>
<tr>
<td>1. Eligible plan</td>
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<td>2. Required distributions</td>
<td>Distributions under an eligible plan are required to commence no later than 60 days after the later of (1)</td>
<td>Distributions would be required (1) to satisfy a payout schedule under which benefits projected to be paid</td>
<td>Same as president's proposal.</td>
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<td>ITEM</td>
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<td>4. Nondiscrimination rules</td>
<td>A tax-sheltered annuity program is not required to meet nondiscrimination requirements of other qualified plans.</td>
<td>No provision.</td>
<td>Generally applies current law qualified plan nondiscrimination rules to TSAs with employer contributions except those maintained by churches. Secretary of the Treasury would be directed to take into account the special circumstances of tax-exempt organizations (including the compressed salary ranges of employees) in applying these nondiscrimination rules. Elective contributions would have to be available to all employees of TSA programs other than those maintained by churches. Effective date. The proposal would be effective for plan years beginning after December 31, 1985. For TSAs maintained by state and local governments rules would generally apply after November 21, 1987.</td>
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<td>inclusion allowance. This is generally equal to 20 percent of the employee's includible compensation multiplied by years of service with the employer and reduced by employer payments to purchase the annuity.</td>
<td>elective deferrals made under tax-sheltered annuity programs. In addition, 403(b) elective contributions would be coordinated with an employee's IRA contributions in the same manner as 401(k) elective deferrals would be coordinated with IRA contributions.</td>
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<tr>
<td>2. Overall limits</td>
<td>Special one-time elections increase the overall defined contribution plan limit. The special elections allow certain catch-up contributions in a year, to the extent permitted by the section 403(b) exclusion allowance. An additional election permits a church employee to elect to increase the overall limit by up to $10,000 for any year, not to exceed a lifetime amount of $40,000 for any employee.</td>
<td>Catch-up elections would be repealed.</td>
<td>Retain current law catch-up provisions, plus new special catch-up provisions for elective contributions.</td>
</tr>
<tr>
<td>3. Withdrawals before age 59 1/2</td>
<td>Withdrawals under a tax-sheltered annuity invested in a custodial account may not commence prior to the time an employee attains age 59 1/2, dies, becomes disabled, separates from service or encounters financial hardship. A 10-percent excise</td>
<td>The proposal would extend the withdrawal restrictions applicable to tax-sheltered annuities invested in a custodial account to all tax-sheltered annuities.</td>
<td>Same as the president's proposal. Additionally, effective for distributions made after December 31, 1985 a 15-percent additional income tax imposed on early withdrawals by an employee from a tax-sheltered annuity or a custodial account, unless</td>
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<td>6. Eligible employers</td>
<td>Proposed regulations leave unclear whether tax-exempt and public employers may establish a CODA.</td>
<td>Tax-exempt and public-sector employers could not maintain a CODA for plan years beginning after 1985 or after collective bargaining agreement.</td>
<td>Tax-exempt and public employers would not be able to establish 401(k) plans. Plans adopted and submitted a determination letter by Nov. 6, 1985, could continue. New nondiscrimination tests and withdrawal restrictions would not apply to grandfathered plans.</td>
</tr>
</tbody>
</table>

C. Tax-sheltered annuities (TSAs)

403(b) plans

1. Limits on elective contributions

<p>| | Employees of public schools and certain tax-exempt organizations may contribute pretax money to a TSA up to a maximum limit known as an ex- | Same as current law. | Effective for plan years beginning after December 31, 1985, the $7,000 section 401(k) dollar limit on elective deferrals would apply to |</p>
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<td>is disqualified.</td>
<td>permitted under the matching contribution rules. Those excess contributions would be subject to a nondeductible 10 percent excise tax, and unless the excess (plus earnings thereon) were distributed by the end of the plan year following the year for which the contributions were made, the plan would be retroactively disqualified.</td>
<td>excise tax, unless the excess plus earnings are distributed by 2 1/2 months after end of plan year following year in which excess contributions were made.</td>
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<td><strong>Effective date.</strong></td>
<td>The proposals would apply generally to plan years beginning after December 31, 1985. For collectively bargained plans, the proposals would apply to plan years beginning after the termination of the collective bargaining agreement.</td>
<td>Same as president's proposal.</td>
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5. **Withdrawals and other restrictions**

A participant in a qualified CODA is not permitted to withdraw elective deferrals (or earnings thereon) before retirement except for reason of death, disability, separation from service, attainment of age 59 1/2, plan termination or the occurrence of a hardship.

Hardship withdrawals would not be permitted. CODAs could not require more than 1 year of service as a condition of eligibility, an employer could not condition either directly or indirectly (other than through matching contributions) contributions and benefits upon an employee's elective deferrals.

Same as president's proposal except that hardship withdrawals would be allowed to the extent of elective deferrals in the plan, withdrawals would be subject to 15-percent excise tax.
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<td>(3) no greater than 100 percent of the employee's mandatory contributions.</td>
<td>Other employer matching contributions. Nonqualifying employer matching contributions are limited to the greater of (1) 110 percent of the percentage of average nonqualifying contributions for the non-highly compensated employees or (2) the lesser of 150 percent of the percentage of average nonqualifying contributions for non-highly compensated employees or the average percentage plus 1 percentage point.</td>
<td>Treasury authorized to prescribe regulations on the extent to which matching, elective and nonelective contributions may be aggregated.</td>
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<td>If the nonqualifying employer matching contributions are tied to elective contributions, then this test would be applied by aggregating nonqualifying employer matching contributions and elective deferrals.</td>
<td>The employer would be denied a deduction for any contributions to highly compensated employees in excess of the amount per-</td>
<td>Same as president's proposal with these modifications: (1) employer would be able to deduct excess contributions and (2) impose a 10-percent</td>
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<td>4. Excess contributions</td>
<td>If employer matching contributions discriminate in favor of officers, shareholders or highly compensated, the plan</td>
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<td>3. Employer matching contributions</td>
<td>If an employer contribution under a qualified plan is conditioned on an employee's contribution, the employer matching contribution (adjusted in an integrated plan for certain Social Security benefits) must be a uniform percentage of compensation.</td>
<td>Two special nondiscrimination tests would be applied to employer matching contribution under any qualified plan. An aggregation rule would apply if employer matching contributions are tied to elective deferrals under a CODA.</td>
<td>Voluntary employee contributions and qualifying employer matching contributions, as a percentage of compensation for highly compensated employees, could not exceed 125 percent of the average of such contributions as a percent of compensation for the nonhighly compensated employees. Alternatively, the average percentage for the highly compensated employees could not exceed 200 percent of the average percentage for the nonhighly compensated employees or the average percentage for nonhighly compensated employees plus 2 percentage points, if less.</td>
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An employer may elect to treat certain employer matching contributions under the special cash or deferred nondiscrimination tests which permit higher contributions (as a percentage of compensation) for the top 1/3 of employees by compensation, but which do not permit Social Security benefits to be taken into account.

Qualifying employer matching contributions. Qualifying employer matching contributions for any highly compensated employee would be limited to the greater of (1) 125 percent of the percentage of average matching contributions for nonhighly compensated employees or the lesser of 200 percent of the percentage of average matching contributions for nonhighly compensated employees or the average percentage

Qualifying employer matching contributions are required to be (1) nonforfeitable when made, (2) ineligible for withdrawal prior to the employee's death, disability, separation form service or plan termination, and

The average of nonqualifying employer matching contribu-
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<td>2. Nondiscrimination requirements</td>
<td>A special nondiscrimination test applies a limit on elective deferrals under a CODA by the group of highly paid employees that is determined by reference to the rate of deferrals by other employees. An employee is considered highly paid, for this purpose, if the employee is one of the highest paid 1/3 of all employees. A CODA meets this special nondiscrimination test for a plan year if: (1) the average deferral percentage (ADP) for the highly paid employees does not exceed the average deferral percentage for the other eligible employees by more than 150 percent, or (2) the average deferral percentage for the highly paid employees does not exceed the average deferral percentage of the other eligible employees by more than (a) 250 percent and (b) 3 percentage points.</td>
<td>Modify the percentage tests and redefine the group of compensated employees in the following ways: Nondiscrimination test. The actual deferral by each highly compensated employee may not exceed (1) 125 percent of the average deferrals of all nonhighly compensated employees or (2) the lesser of 200 percent of the ADP for other eligible employees or the ADP for other eligible employees plus 2 percentage points. Highly compensated employees. The following employees would be treated as highly compensated: (1) 1 percent owners (2) employees earning at least $50,000 (3) employees earning at least $20,000 and among top 10 percent of employees by compensation (4) family members of highly compensated employee.</td>
<td>Nondiscrimination test. The average deferrals by the group of highly compensated employees may not exceed (1) 125 percent of the average deferrals of all nonhighly compensated employees or (2) the lesser of 200 percent of the ADP for other eligible employees plus 2 percentage points. Highly compensated employees. (1) 5 percent owners (2) employees earning at least $50,000 (3) top 10 percent of employees by compensation and paid more than $20,000 excluding employees earning less than $35,000 and not in top 5-percent of all employees (4) family members of highly compensated if family member participate in 401(k) plan.</td>
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<td>of a dependent, or (3) unemployment during a period following the cessation of unemployment benefits.</td>
<td>beginning after December 31, 1985.</td>
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<td><strong>Effective date.</strong> Taxable years beginning after December 31, 1985.</td>
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<td>B. Qualified cash or deferred arrangements (CODAs) (Sec. 401(k) plans)</td>
<td>If a cash or deferred arrangement meets certain requirements, an employee who has a choice of receiving current pay or having that pay deferred under a profit-sharing or stock bonus plan can elect to defer compensation without being taxed as though the compensation had been received.</td>
<td>(The following explains provisions of the president's May 1985 proposal. He subsequently proposed a repeal of section 401(k) plans.)</td>
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<tr>
<td>1. Limit on elective deferrals</td>
<td>Elective deferrals under a qualified cash or deferred arrangement are subject to the overall limits on annual additions under a defined contribution plan. The elective deferrals of any employee (plus employer contributions and certain other amounts) generally cannot exceed the lesser of $30,000 or 25 percent of the employee's nondeferred compensation.</td>
<td>Limit an employee's annual elective contribution to $8,000 coordinated with the dollar limit on IRAs.</td>
<td>The maximum annual elective deferral would be limited to $7,000. 401(k) and 403(b) contributions would reduce IRA deduction limit dollar-for-dollar.</td>
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<td>2. Spousal IRA</td>
<td>An individual is permitted an additional deduction for contributions to an IRA for the benefit of the individual's spouse if (1) the spouse has no compensation for the year, (2) the spouse has not attained age 70 1/2, and (3) the couple files a joint income tax return for the year. The annual deduction limit is increased from $2,000 to $2,250 (or 100 percent of compensation, if less). This contribution may be divided as the spouses choose, provided the contribution for neither spouse exceeds $2,000. If both spouses have any compensation, including compensation less than $250, the spousal IRA deduction is not allowed.</td>
<td>For purposes of calculating the spousal IRA deduction limit, all earned income of both spouses could be considered if the couple filed a joint return. Thus, deductible IRA contributions of up to $2,000 per year to each individual's IRA would be permitted for a couple filing a joint return provided their combined earned income was at least $4,000.</td>
<td>A married couple filing jointly would be able, as under current law, to take a $2,250 total IRA deduction. The total earned income of the couple could be taken into account. A spouse with earnings of $250 or less would not preclude the couple from taking the full $2,250 deduction.</td>
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<tr>
<td>3. Tax on early withdrawals</td>
<td>Amounts withdrawn from an IRA prior to age 59 1/2, death, or disability of the owner are subject to a 10-percent additional income tax.</td>
<td>The additional income tax on IRA withdrawals prior to age 59 1/2, death or disability generally would be increased to 20 percent. The 10-percent tax would continue to apply to distributions made on account of (1) acquisition of participant's first personal residence, (2) the payment of college expenses</td>
<td>Excise tax on early withdrawals would be increased to 15 percent, unless the distribution is part of a scheduled series of level payments under an annuity for the life of the IRA owner (or the joint lives of IRA owner and a beneficiary).</td>
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TABLE 1
Comparison of Employee Benefit Tax Provisions
Current Law, President's May 1985 Proposal and House Bill

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<td>I. Treatment of Tax-Favored Savings</td>
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<td>A. Individual retirement arrangements (IRAs)</td>
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<td>1. General</td>
<td>An individual may deduct annual contributions to an IRA of the lesser of $2,000 ($2,250 for married couples where one spouse has no income) or 100% of the individual's annual compensation includible in gross income.</td>
<td>Increase the annual deduction for a nonworking spouse to $2,000 (no change is proposed for the limit for employed individuals) for taxable years beginning after 1985; limits would be coordinated with the dollar limit on elective contributions under a 401(k) cash or deferred arrangement; consideration would be given to the adoption of rules preventing the deduction of interest on indebtedness incurred to make an IRA contribution.</td>
<td>The current law $2,000 individual limit retained. The individual amount would be reduced dollar-for-dollar, by the employee's elective 401(k) or 403(b) deferral. The spousal IRA limit would be reduced only if the spouse made elective deferrals to a 401(k) or a 403(b).</td>
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