The Internal Revenue Code has provided tax incentives to employers sponsoring qualified pension plans since 1921.

The Tax Treatment of Pension and Capital Accumulation Plans

The pension plan provisions of the Internal Revenue Code (IRC) reflect a longstanding policy of the U.S. government to encourage the broadening of pension coverage. The code has provided tax incentives to employers sponsoring qualified pension plans since 1921. The favorable tax treatment accorded more recent retirement and capital accumulation plans such as 401(k) arrangements, Keoghs, individual retirement accounts (IRAs), and simplified employee pensions (SEPs) is similarly intended to increase voluntary retirement savings and to provide American workers with a funded source of retirement income in addition to Social Security.

Generally, the IRC provides current tax deductions for employer contributions to qualified pension plans; deferral of employee taxes on employer contributions and on investment income; and, in some instances, tax deductions for employee contributions to qualified retirement arrangements.

This tax treatment is contingent on the employer's compliance with nondiscrimination provisions governing employee coverage and benefit levels and other rules set out in the Employee Retirement Income Security Act of 1974 (ERISA).

The tax law governing pensions had been nearly unaltered for decades, but changes have been made almost every year since 1978. The rate of change has made it increasingly difficult for observers to stay informed.

In recognition of the complex and rapidly changing law governing retirement plans and as background for assessing continuing public policy proposals in the area, this Issue Brief presents a brief legislative history of pensions and retirement plans and highlights the tax rules governing them.
Table of Contents

Introduction .............................................................................. 2
Legislative History ................................................................. 3
Early History .......................................................................... 3
Recent History ......................................................................... 3
Tax Principles Governing the Deductibility and Funding of Retirement Plan Contributions .... 4
Qualified Plans ...................................................................... 4
Plan Types .............................................................................. 5
Defined Benefit Plans .............................................................. 5
Maximum Funding Limits ........................................................ 5
Minimum Funding Limits ........................................................ 5
Defined Contribution Plans ...................................................... 7
Maximum Funding Limits ........................................................ 7
Minimum Funding Limits ........................................................ 7
Participants in More Than One Plan ........................................ 7
Top-Heavy Plans ................................................................. 8
Nonqualified Plans .............................................................. 8
Taxation of Plan Contributions ............................................... 9
Mandatory Employee Contributions ........................................ 9
Voluntary Employee Contributions ....................................... 10
Employer Contributions ......................................................... 10
Special Retirement Arrangements ........................................... 11
Section 401(k) ....................................................................... 11
Section 403(b) ....................................................................... 11
Section 457 ........................................................................... 12
Section 414(h)(2) ................................................................. 12
Individual Retirement Accounts ........................................... 12
Simplified Employee Pensions ............................................... 13
Plans for the Self-Employed .................................................... 14
Taxation of Investment Earnings ............................................. 14
Types of Retirement Plan Distributions and Tax Treatment ......................... 15
Periodic Distributions from Accumulated Reserves in the Form of an Annuity .............. 15
Lump-Sum Distributions of Accumulated Pension Contributions and Earnings ........ 15
Estate and Survivor Benefits ................................................ 16
Participant Loans .................................................................. 17
Rollovers ............................................................................. 17
Conclusion ............................................................................ 18
Endnotes ............................................................................. 18


Introduction

The U.S. Congress recognized the need for tax incentives for private pension programs in the Revenue Act of 1921. This and statutes enacted since then, covering income from trusts and pension plans, were intentionally designed to encourage the expansion of pension coverage and increased saving levels and to provide a private source of retirement income in addition to Social Security. Today, private pension and retirement plans number more than 850,000.

The preferential tax treatment accorded more recently developed retirement and capital accumulation arrangements, such as individual retirement accounts (IRAs), simplified employee pensions (SEPs), section 401(k) arrangements, and Keogh plans for the self-employed indicate a continued interest on the part of policymakers in increasing retirement savings.

The tax treatment accorded qualified plans provides incentives both for employers to establish such plans and for employees to participate in them. In general, a contribution to a qualified pension trust is immediately deductible in computing the employer's taxes but only becomes taxable to the employee on subsequent distribution from the plan. In the interim, investment earnings on the contributions are not subject to tax. This preferential tax treatment is contingent on the employer's compliance with nondiscrimination provisions governing employee coverage and benefit levels and other rules set out in the Employee Retirement Income Security Act of 1974 (ERISA). These provisions depart significantly from the general principles inherent in the tax law and reflect longstanding policy decisions aimed at broadening pension coverage and strengthening the pension system.

Plans providing contributions or benefits exceeding statutory limits or not meeting other requirements for qualification may also be used to provide retirement
income. “Nonqualified” plans are generally governed by trust law rather than pension-related tax code provisions.

This Issue Brief describes the legislative history of the tax law as it relates to pensions and other retirement arrangements and the current tax treatment of employer-sponsored qualified and nonqualified plans.

**Legislative History**

**Early History**

Pension plans that provide employer tax deductions and opportunity for the tax-deferred growth of investment earnings have long been permitted under the tax laws. Tax deductions for payments to retirement trusts for current costs were allowed even before specific legislation was enacted, provided the amounts represented reasonable compensation.  

The Revenue Act of 1921 exempted the net interest income of stock bonus and profit sharing plans from current taxation. (This exemption was extended to pension trusts in 1926.)

Also beginning in 1921, employees were not taxed when they made contributions but only when they received distributions from the pension trusts (to the extent that the benefits exceeded the employee’s own contributions).

Before 1928, the tax code did not permit an employer deduction for the funding of pension liabilities for an employee’s services that were performed before the effective date of the pension plan. Consequently, although many employers established balance sheet reserves (reserves that were not put into a separate fund) for this purpose, credits to these reserves were not tax deductible. Influenced by the number and size of these reserves, Congress enacted legislation in 1928 permitting employers to deduct a “reasonable” amount in excess of the amount necessary to fund the current pension liabilities.

Not long afterward, lawmakers became concerned that the legislation governing pensions favored owners, officers, and selected employees without benefiting lower-paid employees. Of specific concern was the fact that a pension trust was not required to be irrevocable, meaning that a pension plan could be dissolved immediately after a sizable tax-deductible contribution had been made. The Revenue Act of 1938 addressed this concern by establishing the “nondiversion” rule and making pension trusts irrevocable. A pension trust is tax exempt only if it is impossible, at any time prior to the satisfaction of all employee liabilities, for any part of the contributions or income to be used for a purpose other than the exclusive benefit of employees or their beneficiaries.

During World War II, pension plans became more widespread as federally imposed wage freezes induced employers and employees to negotiate compensation increases in the form of employer contributions to pension plans. The growing number of pension plans drew attention to their potential misuse as a management tax-avoidance device. To alleviate this problem, the Revenue Act of 1942 established nondiscriminatory employee eligibility rules for pension plan coverage, contributions, and benefits. Under these rules, a pension plan’s eligibility requirements, benefits, and contributions may not discriminate in favor of officers, shareholders, or highly compensated employees. In addition, the act placed limitations on the allowable amount of the employer’s deductions, and rules were developed to integrate pension plans with the Social Security system. These provisions of the Revenue Act of 1942 were incorporated in the Internal Revenue Code (IRC) of 1954, and, along with modifications made by the Tax Reform Act of 1986 (TRA ’86), today constitute the basic rules governing the qualification of pension plans.

**Recent History**

In 1925 there were only about 400 private pension plans in operation, and approximately one-third of the total participants were employed by four of the country’s largest corporations. By 1954 there were about 25,000 pension plans with assets of $23.8 billion. This increase aroused new concern over the potential for fiduciary abuse. The Welfare and Pension Plans Disclosure Act of 1958 (WPPDA) sought to limit fiduciary abuse by establishing certain disclosure requirements. The WPPDA was more concerned with fiduciary standards than with employee rights, however. A 1965 report issued by President Kennedy’s Committee on Corporate Pension Funds expressed concern over the benefits...
denied because of unduly restrictive vesting and forfeiture provisions and the failure of some plans to accumulate and retain sufficient funds to meet their benefit obligations. In response to this concern and to the proliferation of pension plans (371,000 plans with net assets of $218.2 billion existed in 1974), ERISA was enacted.\textsuperscript{13}

In 1925 there were only about 400 private pension plans in operation, and approximately one-third of the total participants were employed by four of the country's largest corporations.

ERISA was intended to establish equitable standards of plan administration, create minimum vesting standards, establish standards of fiscal responsibility by requiring the amortization of unfunded liabilities, insure most vested but unfunded liabilities against premature plan termination, promote "a renewed expansion of private retirement plans," and increase the number of participants receiving private retirement benefits.\textsuperscript{14} ERISA supplemented existing tax provisions by imposing contribution and benefit limits as well as comprehensive requirements for eligibility, vesting, employer deductions, and benefit accruals. The basic tax structure under ERISA was substantially the same as that which had existed since the Revenue Act of 1921.

\textbf{\textcircled{9} Tax Principles Governing the Deductibility and Funding of Retirement Plan Contributions}

The deductibility of employer contributions to retirement plans is governed, in part, by the same tax principles that govern the deductibility of other business expenses under section 162 of the IRC. Employer contributions are required to be otherwise deductible as reasonable compensation for services rendered.\textsuperscript{15} In this respect, the tax laws governing the deductibility of pension contributions are narrower in scope than those governing the deductibility of other forms of compensation because they place a specific limit on the allowable deduction amount and "reasonable compensation" limits.\textsuperscript{16} Also, the rules governing the timing of any business expense deductions are generally broader in scope than those applicable to the timing of deductions for pension contributions. A business expense deduction may be taken in the taxable year during which the expenses are paid or incurred.\textsuperscript{17} Employers using the accrued method of accounting to compute their taxable income are allowed to take the deduction in the taxable year during which all events determining compensation liability have occurred and the amount incurred can be determined with reasonable accuracy (the "all events" test)\textsuperscript{18} even though such compensation is not paid during the taxable year.

In contrast to the rules governing other business expense deductions, section 404 of the IRC requires that pension contributions and other types of deferred compensation must actually be paid to be deductible. This, in effect, puts all employers on a cash-accounting basis for these purposes.\textsuperscript{19} This rule applies to both nonqualified plans and qualified plans that have "...the effect of a stock bonus, pension, profit-sharing, or annuity plan, or similar plan deferring the receipt of compensation."\textsuperscript{20} (In nonqualified plans, it is further required that amounts paid or contributed by the employer be included in the employee's income for tax purposes in order to be deductible by the employer.)\textsuperscript{21}

\textbf{Qualified Plans}

The statutory treatment of the deductibility of contributions to qualified plans is consistent with prestatutory rules governing deductions for payments to pension trusts. Prior to the Revenue Act of 1928, such deductions were permitted based on the theory that the employer had made actual payments to viable trusts as part of compensation, which, if reasonable, were deductible as ordinary and necessary business expenses.\textsuperscript{22} The deduction was not in question, despite the fact that the amounts contributed could revert to the employer in the case of liquidation or revocation of the trust or that the employer retained the right to alter the provisions of the trust.
Subsequent statutory provisions made pension trusts irrevocable (Revenue Act of 1938) and restricted the conditions under which contributed amounts could revert to the employer. When a qualified (defined benefit) plan terminates, only the excess amount resulting from “erroneous actuarial computations” may be returned to the employer, and (under TRA '86) a 10 percent excise tax is imposed on the surplus assets reverting to the employer. In addition, the Omnibus Budget Reconciliation Act of 1987 (OBRA '87) provides that, with certain exceptions, amendments to pension plans permitting reversions to employers may not be made effective until five years after they are adopted. In the case of plans that, as of December 17, 1987, had no provision relating to distribution of plan assets to the employer, this new rule will apply only to amendments adopted after one year after the effective date of the law. Plan provisions adopted before December 17, 1987, and providing for distribution of plan assets to the employer are not affected. OBRA '87 also includes a provision that allocates excess plan assets between employer and employee contributions on a pro rata basis. In many circumstances, this will increase the portion of the excess that must be distributed to employees.

In addition to the deductibility of contributions under the reasonableness limits imposed by IRC section 162, an employer sponsoring a qualified plan may deduct contributions only up to certain dollar limits set by statute. These limits may differ by (1) plan type (e.g., defined benefit, defined contribution, stock bonus, profit sharing); (2) whether employees are covered by more than one plan; and (3) whether the plan falls into a special plan category called top-heavy plans.

Plan Types

Defined Benefit Plans—In a defined benefit plan, the employer agrees to provide the employee with a specified benefit amount at retirement and must arrange to fund this benefit in accordance with the actuarial principles under which the plan is managed.

Maximum Funding Limits—The IRC sets a maximum limit on the amount of contributions for which a tax deduction may be claimed each year by the plan sponsor. As a result of OBRA '87, this limit is the lesser of (1) the normal cost for the year plus amortization over a 10-year period of the initial unfunded actuarial liability and any increases due to changes or actuarial losses; or (2) 150 percent of the plan's current liability, which is defined as all liabilities to employees and beneficiaries under the plan, with the exception of liability for certain benefits that are contingent on certain unpredictable events. The Treasury Department is required to issue regulations by August 15, 1988, which will adjust the 150 percent figure “in a budget neutral manner” to reflect plan participants’ ages and lengths of service. Contributions in excess of the above limits are not deductible to the employer. In practice, however, employers generally contribute only that amount for which they will receive a deduction in the year of contribution. In addition, TRA '86 imposed a 10 percent excise tax on non-deductible employer contributions to pension plans; this tax is imposed each year until a deductible contribution is permissible.

In addition to general limitations, the tax deductibility of contributions is also limited on an individual participant basis under section 415 of the code. A defined benefit plan must provide that the annual benefit for an individual participant cannot exceed the lesser of $94,023 in 1988 or 100 percent of the participant’s average compensation for his or her three highest earning years. Maximum benefits payable to individuals under private-sector defined benefit plans generally must be actuarially reduced if the beneficiary claims benefits before the Social Security normal retirement age, which is scheduled to rise gradually from age 65 to age 67 beginning in the year 2000.

Effective in 1989, there is an overall limit of $200,000 on annual compensation that can be considered for benefit purposes. This, too, will be adjusted for changes in the cost of living in subsequent years. If the plan provides for benefits in excess of the limits, the plan loses its tax qualified status. Any contribution to fund a benefit in excess of the limits is not deductible.

Minimum Funding Limits—A defined benefit plan is also subject to minimum funding requirements. In
In general, the minimum amount an employer must contribute to a defined benefit plan each year is the sum of the normal cost of the plan for the year and the amount necessary to amortize past service costs. This amount is then decreased by the amount necessary to amortize decreases in pension liabilities and experience gains. OBRA '87 substantially tightens the minimum funding requirements and specifies that the new minimum funding provisions (for single-employer plans) must be satisfied through a quarterly payment program.

In practice, employers generally contribute only that amount for which they will receive a deduction in the year of contribution.

As modified by OBRA '87, any single-employer plan with an unfunded current liability (meaning a termination liability and not a projected liability) will have to pay an additional amount to force more rapid funding of liabilities that existed as of December 31, 1987; of new liabilities created after that date; and of liabilities arising from the occurrence of unpredictable contingent events such as a plant closing. The additional charge is limited to the amount necessary to increase the funded current liability percentage to 100 percent.

The additional charge is the amount of the minimum contribution subtracted from the new “deficit reduction contribution.” The deficit reduction contribution is the amount required to amortize the pre-1988 unfunded liability over 18 years; plus the amortization of the new liability, which is a percentage that increases with the amount of under funding; plus amortization over no longer than 7 years for liabilities created by a contingent event. A special rule allows for slower funding of past service liability in a new plan or a newly expanded plan.

OBRA '87 also made changes in prior law that allowed more discretion for actuarial assumptions. Now, for single-employer plans, each actuarial assumption must be reasonable individually, rather than in the aggregate, and special rules apply to interest rate assumptions. The plan must use an interest rate that is not more than 10 percent above or below the average rate for 30-year Treasury bonds for the 4-year period prior to the end of the last plan year. The Treasury may also specify rates, under the appropriate circumstances, that are between 80 and 90 percent of the average rates described above. No rate outside of the “permissible range” is allowed. (Multiemployer plans are exempted from these interest rules, except as applied to the full funding limitations.) Also, for single-employer plans only, the amortization schedule for net experience gains and losses was reduced from 15 years to 5 years, and amortization for gains and losses attributable to changes in actuarial assumptions or methods was reduced from 30 years to 15 years.

A new quarterly payment program imposed by OBRA '87 requires, in the case of a single-employer plan, equal estimated quarterly payments of an employer's minimum funding contribution for the year. It must equal at least 90 percent of the current year's minimum funding requirement or 100 percent of the prior year's, whichever is lower. For plans on a calendar year basis, quarterly payments are due on April 15, July 15, October 15, and January 15. For others, they are due 3.5, 6.5, 9.5, and 12.5 months after the close of the prior plan year.

Failure to comply with these minimum funding requirements leads to the imposition of an excise tax equal to 10 percent of the funding deficiency, and failure to correct the deficiency may result in an additional tax equal to 100 percent of the deficiency. A lien may be imposed against all the assets of the plan sponsor and members of its controlled group for failing to meet any installment payments during the plan year as each payment is missed (if the unpaid balance plus interest exceeds $1 million).

The minimum funding requirements may be waived in certain situations, but minimum funding
waivers for single-employer plans will be far more difficult because of restrictions imposed by OBRA '87. Funding waivers will only be granted if there is demonstrated to the Secretary of the Treasury a temporary substantial business hardship by the plan sponsor and each member of its controlled group in the case of a single-employer plan.

Effective January 1, 1988, the maximum number of waivers granted in the 15 years after that date is reduced to 3 from 5 under prior law. Additional new requirements are imposed on the submission of applications for waivers and on the amortization period and the interest rate to be used in computing the amortization charge for waived contributions. The standards for waivers from the minimum funding requirements for multiemployer plans were not changed by OBRA '87. Thus, hardship need not be temporary and there need not be hardship at a contributing employer’s controlled group level in order for a multiemployer plan to qualify for a funding waiver. Also, multiemployer plans may still obtain 5 funding waivers in a 15-year period.

These minimum funding standards also apply to defined contribution plans that are money purchase plans (where contributions are expressed as a percentage of covered payroll), but not to other defined contribution plans.

**Defined Contribution Plans**—In a defined contribution plan, the employer makes specified contributions to the employee’s account and, on termination of employment, the employee is entitled to the value of the vested part of the account. A defined contribution plan thus requires the establishment of an individual account for each participating employee, since it is funded through the accumulation (including income and capital appreciation) of the contributions made on behalf of each employee.

There are several types of defined contribution plans: money purchase pension plans (where employer contributions are stated as a percentage of employer salary); target benefit plans (where contributions are scaled to achieve a specified retirement benefit); profit sharing plans (including 401(k) arrangements) thrift plans, stock bonus plans, and employee stock ownership plans (ESOPs), which traditionally invest in employer securities.

**Maximum Funding Limits**—In general, annual additions to defined contribution plans may not exceed the lesser of 25 percent of an employee’s compensation or $30,000. The IRC further limits the maximum deductible contribution to profit sharing and stock bonus plans to an amount equal to 15 percent of the compensation of all participants.

**Minimum Funding Limits**—If less than 15 percent is contributed in any year beginning before January 1, 1987, the balance of the deductible amount for that year may be carried forward for deduction in a later year, but the later year deduction may not exceed 25 percent of the participant’s total compensation for the year.

ESOPs are subject to special additional restrictions regarding the type of permissible investments in employer securities under so-called “floor offset” arrangements and regarding the need for diversification of ESOP investments.

**Participants in More Than One Plan**—In addition to limiting contributions to separate plans, section 415 of the IRC imposes further contribution limitations when an employee participates in both a defined benefit and a defined contribution plan sponsored by the same employer. Section 404(j) of the code denies any deduction for amounts contributed to fund or provide benefits in excess of the limits.

The limits are expressed both as a percentage of compensation and as dollar amounts. In general, combined contributions for participants covered by both types of plans may not exceed 125 percent of the specific dollar limit placed on each plan. For example, if the employee’s defined benefit plan provides a benefit equal to 80 percent of the dollar limit of that plan and the employee’s contribution to a money purchase pension plan equals 45 percent of the dollar limit on that plan, the combined contributions for the individual employee-participant are still in compliance with the law. Together they equal 125 percent of the dollar limits applicable to each plan separately.
If a plan participant’s benefits and contributions do not exceed dollar limits, then the contributions and benefits in both types of plans can equal up to 140 percent of the limits placed on the plans separately. As discussed earlier, those limits are as follows: for defined-benefit plans, 100 percent of the average compensation for the employee-participant’s three highest-earning years (with limits on maximum compensation effective in 1989); and, for defined contribution plans, 25 percent of the participant’s compensation.34

In addition to limiting contributions to separate plans, section 415 of the IRC imposes further contribution limitations when an employee participates in both a defined benefit and a defined contribution plan of the same employer.

An additional limit is placed on the employer’s tax deduction when one or more employees are covered by both a pension or annuity plan and a profit sharing or stock bonus plan. If this is the case, the total deduction for contributions to all plans may not exceed either 25 percent of compensation paid or accrued to all plan participants during the taxable year or, if greater, the contribution necessary to satisfy minimum funding standards for that year. Excess amounts contributed may be deducted in succeeding taxable years subject to the 25-percent limit in the year deducted.35

**Top-Heavy Plans**—The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) established a new category of plans known as “top-heavy” plans. A plan is top heavy if 60 percent or more of the accounts or accrued benefits under the plan are attributable to key employees, defined as: officers (revised in 1984 to exclude those earning less than 1.5 times the dollar limit on contributions in a defined contribution plan); the 10 employees owning the largest shares of the employer; owners of more than a 5 percent interest in the employer; or owners of more than a 1 percent interest in the employer who receive compensation from the employer in excess of $150,000.

A top-heavy plan must satisfy certain requirements concerning the benefits or plan contributions for non-key employees. The plan must meet one of two accelerated vesting schedules and certain minimum benefit or plan contribution requirements. In determining plan contributions or benefits, only the first $200,000 of an employee’s compensation will be taken into account.

**Nonqualified Plans**

The statutory treatment of employer deductions for deferred compensation under nonqualified plans differs substantially from prestatutory rules governing such deductions. Prior to the Revenue Act of 1942, unfunded noncontingent liabilities incurred to pay deferred compensation were tax deductible by an accrual-basis employer even though such amounts were paid and includable in the employee’s gross income in later years.36 Payments to trustees under deferred income plans were also deductible as long as the amount could revert to the employer only in situations beyond the employer’s control.37

Under the Revenue Act of 1942, the employer was permitted a tax deduction only (1) on the payment of benefits (unfunded plans); or (2) if the employee’s interest was nonforfeitable at the time the contribution was made (funded plans).38 Although the Tax Reform Act of 1969 continued the rule governing unfunded plans, it substantially revised the treatment of funded plans by permitting the employer to take a deduction when the employee’s interest became vested even though the employee’s interest had been forfeitable at the time the contribution was made.39 The Internal Revenue Service (IRS) had previously taken the position that the employer was never entitled to a deduction for contributions in which an employee’s interest was forfeitable when the contribution was made.40

Current statutory treatment of tax deductions for nonqualified plan contributions restricts their availability. Deductions are still available for employer liabilities calculated on an accrual basis if there is no deferral of compensation.41 Contributions to nonqualified plans are
deductible only when paid and included in the employee’s gross income. This requirement is met in unfunded plans when payments are actually made to the beneficiary and in funded plans when the employee’s rights in employer contributions are not subject to a substantial risk of forfeiture. Contributions to qualified plans are also deductible only when paid; however, they are deductible whether or not plan participants are vested or contributions are included in their gross income. In addition, in nonqualified plans, the employer’s deduction is available only if separate accounts for each employee are maintained.

The statutory treatment of employer deductions for deferred compensation under non-qualified plans differs substantially from prestatutory rules governing such deductions.

Taxation of Plan Contributions

Under general tax principles, income is taxed when it is constructively received, that is, when it comes into an individual’s substantial control and discretion. For example, when an individual assigns a third party his or her right to receive compensation for past services, the individual—not the third-party recipient—is taxed on the income assigned. Income earned on invested capital, for example, is generally deemed taxable when the individual retains substantial control or discretion over it. Under general tax rules, therefore, employee contributions to pension plans are currently taxed to the employee, that is, as they are earned. These rules apply regardless of whether the employee contributions are voluntary or mandatory. In the former instance, the contribution is solely at the discretion of the employee. In the latter, although mandatory contributions are a condition for participation in the plan, it is within the employee’s control to decide whether or not to participate in the plan under the conditions imposed. Similarly, where participation in a plan is a condition of employment, the individual has the option of not taking the job.

Employee contributions are provided for by some plans both to increase retirement savings and to reduce the employer’s plan costs. The IRC imposes limits on both the mandatory and the voluntary amounts employees may contribute to qualified plans. Limits on the mandatory contribution amount are aimed at eliminating the risk that the contribution requirements will result in prohibited patterns of discrimination. If employee contribution requirements are particularly burdensome, they could indirectly exclude employees from participation. The statutory limits on voluntary contributions, in turn, are aimed at preventing a qualified plan from offering excessive benefits to highly compensated employees in the form of savings accounts accruing tax-deferred interest.

Mandatory Employee Contributions

Employee contributions are considered mandatory if they are required as a condition of employment, a condition of plan participation, or a condition of receiving employer contributions. As a general rule, mandatory contributions cannot be so burdensome as to permit participation only by highly paid employees, thus discriminating against lower paid employees. While most required contributions are not deductible, earnings accumulated on these contributions are not taxed until distributed.

Mandatory employee contributions are found in relatively few private employer plans. In 1986, the most recent year for which U.S. government data are available, only 6 percent of participants in private defined benefit plans and 34 percent of participants in “retirement” defined contribution plans paid part of the cost of their plans. Also, there is evidence that the relative importance of employee contributions in private employer plans had been declining sharply until the early 1980s. In a 1980 survey of 325 plans accounting for 8.2 million participants, Bankers Trust Company found that the number of contributory plans fell from 33 percent in 1975 to 19 percent in 1980. This trend could reverse in the future, however, as section 401(k) arrangements continue to grow in popularity (discussed below).
Unlike private-sector plans, public-sector plans are predominantly contributory. In 1987, 78 percent of governmental pension plan participants had to pay part of the cost of their defined benefit plans. The typical plan requires contributions of 5 percent to 8 percent of salary. Employee contributions accounted for approximately 27 percent of total contributions to these plans in 1985-1986. About 44 percent of the much smaller group of governmental participants (9 percent) in defined contribution plans paid part of the cost of their plans in 1987, although 16 percent of employees participated in separate, free standing tax-deferred annuity [(403(b)] plans (discussed below) that were not matched by employer contributions.

Federal civilian employees hired before January 1, 1984, contribute 7 percent of compensation annually to the Civil Service Retirement System. They also may make voluntary contributions (without a match from the employer, the federal government) to a supplemental thrift plan. These federal employees are not directly covered by Social Security, but they do pay the Medicare Hospital Insurance payroll tax and are eligible for Medicare. Federal civilian employees hired after January 1, 1984, contribute to Social Security and Medicare; they are also covered by a noncontributory defined benefit plan; and they may also choose to contribute to a voluntary thrift plan that provides for matching contributions from the government. Beginning in fiscal year 1985, the federal government has made contributions for military retirement benefits on an accrual basis, but the plan continues to be noncontributory for military personnel.

Voluntary Employee Contributions

Generally, voluntary employee contributions to employer-sponsored plans are not tax deductible—they are made with "after tax" dollars. Under special statutory rules, however, certain employee contributions may be made with "before-tax" dollars (thereby becoming tax deductible). This is true despite the fact that in some cases (IRAs, for example) the employee has actually received the compensation being saved for retirement and is immediately vested. In a cash or deferred arrangement under section 401(k) of the IRC, the employee exercises discretion and control by annually electing whether or not to forgo cash compensation in favor of deferred compensation that vests immediately, but amounts deferred are not included in the employee’s gross income until actually received. Similar plans for certain nonprofit institutions and state and local governments are authorized under IRC section 403(b). In addition, public-sector employees may participate in arrangements under section 457. And a special arrangement is available to government plans, section 414(h)(2), in which employee contributions characterized as employer contributions are excludable from current gross income for federal income tax purposes. (These arrangements are discussed below.)

The reason these special statutory rules depart from traditional tax principles is policy-oriented. Congress believed that individual retirement saving was necessary to enable retirees to maintain preretirement standards of living and that the level of saving has not been adequate for that purpose. In addition to promoting individual retirement saving (a needed supplement to the Social Security system) and supplementing pension plans with deferred vesting schedules, tax-deductible employee contributions remove the responsibility for retirement saving from the sole discretion of the employer and provide added insurance against the possibility of early plan termination or the employee’s involuntary separation from service by layoff or firing.

Thus, these special arrangements do not exist within the confines of accepted pension tax principles: they are, instead, Congress’ response to the need for increased levels of private retirement saving. (These arrangements are more thoroughly discussed below.)

Employer Contributions

The tax treatment of employer contributions is determined by qualified plan status. Since the Revenue Act of 1921, employees have not been taxed on employer contributions to qualified plans until distribution. This is true whether or not the employee is vested under the plan. Of course, before being vested the employee cannot be taxed on employer contributions since this interest is forfeitable; however, once vested, this interest is nonforfeitable and not subject to sufficiently substantial conditions as to preclude taxation under the general rule even though the benefits may not be payable until a later date (e.g., retirement or attainment of a certain age).
In unfunded nonqualified plans, the employee is taxed on receipt of benefits. However, in funded nonqualified plans the employee must include as income the value of the accrued benefits not subject to substantial risk of forfeiture. There exists a "substantial risk of forfeiture" if the employee’s right to full enjoyment of the property is conditioned on his or her future performance of substantial services or other substantial conditions related to the purpose of the transfer of the property. When such a risk does not exist, the employee’s rights to the employer’s contributions in a nonqualified plan are deemed vested and that amount is taxable.

Nonqualified plans have historically tended to be unfunded. Nevertheless, most employers establish balance sheet reserves to cover the plans. ERISA established regulatory (nontax) funding standards for nonqualified plans but exempted many of the more usual types of nonqualified plans from these standards.

Accrued benefits under unfunded plans are financed either from current operating income or from previously established reserves on the employee’s retirement, and the employer takes a tax deduction for payment of benefits at that time. Employees pay taxes on retirement income at their post-retirement marginal tax rate, but run the risk of the employer’s financial inability to pay benefits.

*** Special Retirement Arrangements ***

As mentioned above, Congress has authorized special arrangements that allow employees to save more money on their own for retirement on a tax-deferred basis. In addition, Congress has legislated separate plans designed to provide for the special needs of small businesses and the self-employed.

Section 401(k)

The Revenue Act of 1978 authorized cash or deferred arrangements under IRC section 401(k). An employee may elect to have a portion of compensation (otherwise payable in cash) contributed to a qualified profit sharing or stock bonus plan. These contributions are not treated as distributed or available (taxable) income to the employee but as deductible employer contributions to the plan. Section 401(k) arrangements have achieved considerable popularity since 1981, when IRS published proposed regulations clarifying their implementation. Final regulations were published in early August.

As long as the 401(k) arrangement meets specific participation and nondiscrimination standards, contributions and deductions are governed by the same rules as other defined contribution plans except that the maximum employee elective contribution cannot exceed $7,313 in 1988. The limit is indexed for annual changes in the cost of living. Because of a change made by TRA ’86, a nonprofit organization cannot maintain a section 401(k) plan unless it was adopted before July 2, 1986, and a state or local government or political subdivision may not maintain such a plan unless it was adopted before May 6, 1986.

Section 403(b)

A special type of tax-deferred retirement arrangement under section 403(b) of the IRC is available to certain nonprofit organizations and public schools, including public colleges and universities. In plan years beginning after December 31, 1988, tax deferred annuities (TDAs) must satisfy, with respect to contributions not made pursuant to salary reduction, essentially the same nondiscrimination rules and participation rules as qualified retirement plans. In addition, special nondiscrimination rules will apply to elective contributions made by employees through salary reduction.

Annual contributions to a TDA cannot exceed a maximum limit referred to as an exclusion allowance. The exclusion allowance is generally equal to 20 percent of the employee’s includable compensation from the employer multiplied by the number of the employee’s years of service with that employer, reduced by amounts already paid by the employer to purchase the annuity. In addition to the limit imposed by the exclusion allowance, TRA ’86 limits employee contributions made through salary reduction to $9,500 annually, coordinated with contributions to a 401(k) plan. The limit applies until the indexed 401(k) limit ($7,313 in 1988) reaches $9,500, at which time the TDA limit will also be indexed in the same manner as the 401(k) plan limits. If an employee is required to contribute a set...
percentage of compensation to a TDA as a condition of employment, the contribution does not count toward the annual limit. In addition, a special annual catch-up election, available for employees of educational organizations, hospitals, home health agencies, health and welfare service agencies, or churches or conventions of churches, allows larger salary reduction contributions for an eligible employee who has completed 15 years of service.

Section 457

This special section of the IRC contains rules applicable to deferred compensation arrangements of state and local governments or agencies and instrumentalities of either. Deferred compensation plans for tax-exempt organizations were made subject to section 457 by provisions of TRA ’86.

Amounts of compensation deferred under a section 457 deferred compensation plan are not taxed to the employee as current income but are taxed as income when received. It is not required that a section 457 deferred compensation plan be offered to all employees on a nondiscriminatory basis. Among numerous requirements that a section 457 plan must meet, the amounts deferred are limited to no more than 33 1/3 percent of includable compensation or $7,500, whichever is less. Any amounts being deferred under a section 403(b) tax-deferred annuity must be taken into account in determining whether the overall $7,500 limit has been exceeded. The exclusion allowance of a section 403(b) tax-deferred annuity and the includable compensation on which it is figured are affected by amounts deferred under section 457.

Section 414(h)(2)

Another arrangement under which pension plan participants may defer taxation on amounts contributed to a pension plan is available only to public employees under an arrangement known as “employer pick-up.” Under retirement plans maintained by any state or political subdivision, section 414(h)(2) of the IRC provides that the employing unit may “pick up” contributions that have been designated by the plan as employee contributions. When such contributions are picked up, they are treated as if they were made by the employer instead of by the employee. “Picked up” employee contributions are not currently taxable as income to the employee but are instead taxed later when received as pension income.

In establishing IRAs, Congress intended to offer workers who did not have employer-sponsored pension coverage an opportunity to set aside tax-deferred compensation for use in retirement.

Amounts of employee contributions that are assumed by the employer under a pick-up arrangement must be taken into account in determining the exclusion allowance in setting amounts that may be additionally tax deferred through section 403(b) tax-deferred annuities. However, the overall limit of $9,500 for elective deferrals under tax-deferred annuities is not reduced by the amount of an individual’s employer pick up. Public employee, state teacher, or university retirement systems in at least 18 states currently use a pick-up arrangement.

Individual Retirement Accounts

An IRA is a separate trusted account in which an individual has a nonforfeitable interest. IRAs were established by ERISA in 1974. In establishing IRAs, Congress intended to offer workers who did not have employer-sponsored pension coverage an opportunity to set aside tax-deferred compensation for use in retirement. The 1981 Economic Recovery Tax Act (ERTA) extended the availability of IRAs to all American workers (i.e., even those who already had employer-sponsored pension coverage). TRA ’86 retained tax-deductible IRAs for those who are not “active participants” in an employer-sponsored plan but restricted or eliminated the tax deduction for those who are active participants in an employer-sponsored retirement plan to taxpayers with incomes above specified levels. TRA ’86 added two new categories of
IRA contributions: nondeductible contributions that accumulate tax free until distributed; and partial, deductible contributions, which are fully deductible contributions for a maximum amount that is less than the $2,000 maximum contribution otherwise allowable.

Single workers can contribute up to $2,000 or 100 percent of earned income (whichever is lower) per year if they are not active participants in an employer-sponsored plan or if they are active participants and have an adjusted gross income (AGI) of less than $25,000. For those with an AGI of between $25,000 and $35,000, the deductible IRA is prorated: a $10 reduction in the $2,000 maximum is made for each $200 (or part thereof) above $25,000 but not below $200 if the individual is otherwise eligible to make any deductible contribution; nondeductible contributions are allowed for the balance of the $2,000 maximum limit. Above $35,000 in AGI, only nondeductible contributions are allowable to single workers.

Where a husband and wife both earn income, each may contribute up to $2,000 or 100 percent of earned income (whichever is lower) per year. A two-earner couple can therefore make a combined contribution of up to $4,000. Where a husband and wife file a joint return and either spouse is covered by an employer-sponsored plan, both are restricted in their eligibility to make deductible IRA contributions under the rules that apply to their combined AGI. In other words, they are each allowed: fully deductible contributions up to $2,000 if their combined AGI is below $40,000; a deductible IRA contribution of less than $2,000 and a nondeductible IRA contribution for the balance of the $2,000 if their combined AGI is between $40,000 and $50,000; and no deductible IRA if their AGI is $50,000 and above (a $2,000 nondeductible IRA contribution would be allowed for each working spouse).

A married worker with a nonworking spouse can contribute up to $2,250 or 100 percent of the employed spouse’s earned income (whichever is lower) per year only if the worker is not an active participant in an employer-sponsored plan or is an active participant but has AGI below $40,000. The dollar limit on deductible contributions to a spousal IRA is phased out (i.e., reduced) for active pension plan participants in accordance with the same rules that apply to worker IRAs.

All taxable alimony received by a divorced person is treated as compensation for purposes of the IRA deduction limit, and the regular IRA eligibility rules apply.

An employer can contribute to an IRA on behalf of the employee or also offer employee IRAs through payroll deduction arrangements.

The law permits individuals to roll over account balances from: (1) one IRA to another and (2) a qualified employer plan to an IRA. To avoid tax penalties, the transfer of assets from one account to another must be completed within 60 days.

Simplified Employee Pensions

SEP's are employer-sponsored plans that have some features in common with IRAs. In a SEP, the employer contribution is limited to the lesser of 15 percent of compensation or $30,000, which includes amounts that employees elect to contribute through salary reduction. An employer may contribute to a SEP in addition to contributing to other qualified pension plans, but the SEP contribution will count in the total deductible limit on employer contributions to all qualified plans.

TRA '86 expanded the possibilities for employee participation in a SEP by providing a salary reduction option, which is available to employees in firms with 25 or fewer employees if 50 percent of all eligible employees elect to participate.

The employer contribution is channeled into an IRA maintained for the individual employee. For tax purposes, employer contributions are treated as if they were paid to the employee who then contributed that amount to an IRA, so the employee may deduct the amount deemed so contributed from adjusted gross
income. Employees are fully and immediately vested in the employer’s contributions and the investment earnings on the contributions.

TRA ’86 expanded the possibilities for employee participation in a SEP by providing a salary reduction option, which is available to employees in firms with 25 or fewer employees if 50 percent of all eligible employees elect to participate. The maximum deferral is $7,313 (indexed), reduced by any salary reduction contributions to a 401(k) or 403(b) plan. A special nondiscrimination test also applies whereby no single highly compensated employee can defer through salary reduction more than 125 percent of the average deferral percentage for all other eligible employees.

Employer contributions and employees’ elective deferrals to a SEP are excluded from the employee’s taxable income. Contributions and earnings in the SEP accumulate tax free until withdrawn.

The SEP plan must permit employer contributions to be withdrawn at any time by the employee, and continued employer contributions may not be conditioned on any portion of employer contributions remaining in the account. Earnings accumulated on employer contributions are not taxed to the employee until distributed. SEPs are subject to the same penalties on premature withdrawals as IRAs.

As a result of TRA ’86, an employee covered under a SEP may not be able to make fully deductible contributions to his or her own IRA unless he or her adjusted gross income falls below $25,000 (single) or $40,000 (married), as described above.

Plans for the Self-Employed

Self-employed individuals and noncorporate employers can now establish retirement plans similar to those available to corporate employers. Prior to the passage of TEFRA, Keogh, or H.R. 10, plans were subject to more stringent limits on contributions than were corporate plans. In addition, Keogh plans benefiting an owner-employee (a sole proprietor or partner whose partnership interest exceeds 10 percent) were required to meet special standards with respect to plan coverage, vesting, distributions, and other matters affecting the security of employee benefits. Reflecting the belief that the level of available tax incentives encouraging retirement savings should not depend on whether the employer is incorporated or not, TEFRA repealed the special rules for Keogh plans and generally eliminated the distinctions between qualified plans of corporate and noncorporate employers. Some of the special rules formerly applicable only to Keogh plans and intended to prevent abuse with respect to the provision of retirement benefits were retained, however, and made generally applicable to all tax-qualified plans. In addition, other rules formerly applicable only to plans for the self employed were made applicable to all top-heavy plans.

Keogh plans are now on a par with corporate qualified plans with respect to limits on contributions and benefits.

Keogh plans are now on a par with corporate qualified plans with respect to limits on contributions and benefits. Furthermore, all qualified plans are now subject to the former Keogh rules relating to the timing of benefit distributions and the integration of defined contribution plans with Social Security. Top-heavy plans are subject to special limitations concerning includable compensation, vesting, distribution, and minimum nonintegrated benefits or contributions, many of which formerly applied only to Keogh plans that benefited owner-employees.

Taxation of Investment Earnings

Generally applicable tax principles suggest that either the employer or the trust should be taxed on a qualified trust’s investment earnings. Under the tax laws generally applicable to ordinary trusts, the employer would be taxed on a plan’s investment income if it retained either a reversionary interest in plan assets due to vesting contingencies or substantial powers over the
trust (such as the right to appoint trustees or to substantially alter the provisions of the trust). If the employer does not retain a reversionary interest or sufficient power over the plan, the trust would be taxed on trust income not distributed to participants.

In a nonqualified trust, the employer is taxed on investment earnings until the amounts become vested in the employee. At that time, the trust becomes taxable on earnings until the amount is distributed to the employee.

Since the Revenue Act of 1921, the investment earnings of a qualified pension trust have not been subject to taxation until they are distributed. This rule applies even though, under current statutory provisions, an employer may retain the right to appoint trustees or to alter, amend, or terminate a pension plan.

Types of Retirement Plan Distributions and Tax Treatment

Under the statutory scheme, special rules govern the treatment of distributions from qualified plans. These rules were substantially modified by TRA '86. The rules are wide ranging: in some instances they automatically terminate the tax-deferred status of amounts distributed; impose a tax penalty for preretirement lump-sum distributions; impose a tax penalty on large distributions; and, in certain other cases, provide further favorable tax treatment after distributions are completed.

Periodic Distributions from Accumulated Reserves in the Form of an Annuity

As a general rule, distributions from a qualified trust, previously funded with deductible employer contributions and enhanced with tax-free earnings, are includable in full in the gross income of the employee when received. Thus, benefits payable in the form of an annuity are only included in the employee's income as payments are received. If the employee contributes some of the amount necessary for the purchase of the annuity, the employee's previously taxed contributions may be recovered tax free, but on a pro rata basis over the term of the annuity. The earnings on annuities funded with employee contributions generally are subject to tax, even if these contributions are made with after-tax dollars. Contributions by (or on behalf of) the employee to IRAs, SEPs, and 401(k)s, however, are usually made with pretax dollars; accordingly, retirement benefits attributable to such contributions are fully taxable on receipt.

Lump-Sum Distributions of Accumulated Pension Contributions and Earnings

A lump-sum distribution to an employee who is not self-employed may be entitled to special tax treatment if it is a distribution of an employee's total accrued benefit made within a single taxable year and made on the occasion of the employee's death, attainment of age 59 1/2, or separation from the employer's service. Self-employed individuals may receive lump-sum distribution treatment only in the case of death, disability, or the attainment of age 59 1/2. A distribution of an annuity contract from a trust or an annuity plan may be treated as a lump-sum distribution.

TRA '86 substantially changed the tax treatment of lump-sum distributions. Under prior law, which is still applicable to certain individuals covered by a transition rule, favorable capital gains treatment and 10-year forward income averaging applied. Amounts distributed as a lump sum from a qualified plan were separated into pre-1974 amounts and post-1973 amounts. This computation was made by multiplying the amount distributed by a fraction: the numerator was the number of months of active participation in the plan before January 1, 1974, and the denominator was the total number of months of active participation. The resulting sum was deemed the pre-1974 portion and, in the absence of the election described below, was taxed as a long-term capital gain. Such treatment may have been favorable to the taxpayer because only 40 percent of such capital gain was subject to tax. The balance of the lump-sum distribution was deemed the post-1973 portion and was treated as ordinary income.

An employee participating in the plan for 5 or more years prior to distribution could elect to use a special 10-year forward income averaging method to compute the amount of tax on the post-1973 amount. Under this special income averaging rule, a separate tax was
computed at ordinary income rates on one-tenth of the post-1973 amount (less a minimum distribution allowance), and the resulting figure was multiplied by 10. Because of our progressive income tax rates and the fact that this tax was computed separately from the taxpayer's other income, the 10-year forward income averaging rule could result in substantial tax savings.

A separate election could be made to treat all pre-1974 amounts as ordinary income eligible for 10-year forward income averaging. Such an election could be advantageous since, depending on the amount of the distribution, 10-year forward income averaging might have produced a lower tax on the pre-1974 amount than would capital gains treatment. The election was irrevocable and applied to all subsequent lump-sum distributions received by the taxpayer.

TRA '86 phases out capital gains treatment for lump-sum distributions over 6 years beginning January 1, 1987, and eliminates 10-year forward averaging for taxable years beginning after December 31, 1986, and instead permits a one-time election of 5-year forward averaging for a lump-sum distribution received after age 59 1/2. Under a transition rule, a participant who attained age 50 by January 1, 1986, is permitted to make one election of 5-year forward averaging or 10-year forward averaging (at 1986 tax rates) with respect to a single lump-sum distribution without regard to attainment of age 59 1/2 and to retain the capital gains character of the pre-1974 portion of such a distribution. Under the transition rule, the pre-1974 capital gains portion would be taxed at a rate of 20 percent. TRA '86 also imposes a 15 percent excise tax on distributions to an individual in excess of specified limits (currently up to $150,000 in a year, or $750,000 if a lump sum).

Lump-sum distributions from 401(k)s are eligible for lump-sum treatment. IRA and 403(b) lump-sum distributions, however, are not.

TRAJ 86 imposed a 10 percent additional tax on lump-sum distributions paid to individuals before age 59 1/2 from most tax-favored retirement plans. (Before TRA '86, it only applied to distributions from IRAs and SEPs.) The tax does not apply to the return of employee after-tax contributions (but it does apply to the earnings thereon) or to amounts rolled over to an IRA or other qualified plan. It also does not apply to distributions from section 457 plans of state and local governments or to certain distributions from an ESOP prior to January 1, 1990. The 10-percent penalty is not imposed if the distribution is taken after age 59 1/2 or taken in the form of an annuity. Payments made after the participant has separated from service on or after age 55, used for payment of medical expenses to the extent deductible under federal income tax rules, or made to or on behalf of an alternate payee pursuant to a qualified domestic relations order are exempt from the penalty tax.

Estate and Survivor Benefits

Benefits not attributable to the employee's own contributions are, within certain limits, excluded from the decedent's estate. The value of annuity payments from a qualified trust is excluded from the decedent's gross estate in an amount not to exceed $100,000. Similarly, a lump-sum distribution from a qualified trust is excluded from the gross estate in an amount not to exceed $100,000, only if the recipient of the distribution irrevocably opts not to elect lump-sum treatment for income tax purposes. Of course, any amounts received during
the lifetime of the decedent or attributable to amounts accumulated under nonqualified plans are includable in the decedent’s estate. Similarly, a participant who has elected to provide a survivor benefit based on accrued benefits under the plan is deemed to have made a gift to the beneficiary to the extent that the survivor benefit is based on the employee’s own contributions.

Participant Loans

Loans to participants from qualified trusts are a use of pension assets that has received some policy attention in recent years. Prior to the passage of TEFRA, loans to participants from plan assets were subject only to the rules governing other plan investments: the loan had to bear a reasonable rate of interest, be adequately secured, and provide a reasonable repayment schedule. Participant loans were generally secured by that portion of the participant’s interest in the plan that was nonforfeitable at the time the loan was made. It was further required that plan loans be made available to all participants on a nondiscriminatory basis.

By 1982, Congress had become concerned that widespread borrowing from plan reserves could reduce the role of plans as retirement savings.

By 1982, Congress had become concerned that widespread borrowing from plan reserves could reduce the role of plans as retirement savings. At the same time, legislative debates reflected the concern that prohibiting loans entirely could discourage voluntary participation among employees who might need access to such funds during financial emergencies.65

In response to these concerns, TEFRA added new provisions restricting plan loans under IRC section 72: loans are to be treated as plan distributions unless they meet certain requirements. The requirements were further tightened by TRA ’86.

For loans after December 31, 1986, the amount of new loan plus the outstanding balance of all other plan loans cannot exceed the lesser of (a) $50,000, or (b) the greater of one-half of the present value of the employee’s nonforfeitable accrued benefit under the plan or $10,000. As a result of TRA ’86, the $50,000 limit is reduced by the excess of the highest outstanding loan balance during the one-year period ending on the day before the new loan is made, over the outstanding balance on the date of the loan. This was intended to prevent a plan participant from maintaining a permanent $50,000 loan through the use of balloon payments and bridge loans from third parties.66

Loans must be repaid within five years. A longer term is available only for loans used to acquire the participant’s principal residence. The loan must require substantially level amortization payments, payable at least quarterly. The deductibility of interest on plan loans follows the general income tax rules, except that interest on loans made to a “key employee” or attributable to elective deferrals under a 401(k) or tax-deferred annuity is never deductible. Nondeductible interest paid to the plan also does not increase the individual’s basis in a plan or tax-deferred annuity. Loans from IRAs are treated as distributions under all circumstances, regardless of whether the requirements applicable to qualified-plan loans are met. Similarly, the pledging of an IRA as security for a loan will result in the amount being treated as if it were distributed. In addition, loans to owner-employees from Keogh plans continue to be prohibited transactions.

Rollovers

In general, lump-sum distributions attributable to employer contributions from a qualified pension trust or an IRA may be rolled over tax free into other qualified plans if the transfer is made within 60 days of the participant’s receipt of the distribution from the first plan. (Employee contribution may not be so rolled over.) Thus, an employee who receives a lump-sum distribution on severance of service with one employer generally may, without having that sum counted as income, redeposit all or part of the distributed amount in the qualified plan of a new employer (if that plan permits) or in an IRA. TRA ’86 specified that a partial distribution from a qualified plan may be rolled over to
another qualified plan only if the distribution is at least 50 percent of the participant's account balance and only if the distribution is made because of separation from service or the death or disability of the covered employee. If an amount otherwise eligible for the special lump-sum tax treatment discussed above is rolled over into an IRA, the special tax treatment is not available on subsequent distribution from the IRA.

**Conclusion**

The deductibility of employer contributions to qualified pension trusts under current law is consistent with prestatutory law governing such deductions. The statutory treatment of trust earnings and plan participants dates from 1921 and represents a departure from general tax principles inspired by the express policy goals of encouraging retirement savings, and providing a private, in addition to a public, source of retirement security. The tax-favored treatment of qualified pensions is thus not a recent development but rather was present in early statutory rules and prior nonstatutory law. While of more recent vintage, the favorable treatment accorded IRAs, SEPs, 401(k)s, and 403(b)s is similarly intended to increase voluntary individual retirement savings. Although an employer's payments to employees under nonqualified plans will eventually generate a tax deduction, the additional tax benefits accorded plans that meet the requirements of qualified status are incentives to employers and employees alike to establish and participate in qualified plans.

**Endnotes**

1. Elgin National Watch Co. v. Commissioner, 17 B.T.A. 339, 358-60 (1929); Hibbard, Spencer, Bartlett & Co. v. Commissioner, 5 B.T.A. 464, 474 (1926). However, no deduction was permitted for additions to pension funds or reserves held by the employer until such amounts were actually paid to the employee. Also see Reg. 45, art. 108 (Revenue Act of 1918); Reg. 65, art. 109 (Revenue Act of 1924); and Reg. 69, art. 109 (Revenue Act of 1926).

2. Revenue Act of 1921, sec. 219(f).


4. Revenue Act of 1921, sec. 219(f). Such a provision is currently codified in the Internal Revenue Code, secs. 72 and 402.

5. Revenue Act of 1928, sec. 253(q).


8. Revenue Act of 1942, sec. 162(b), amending section 165(a) of the Internal Revenue Code (1939).


15. Internal Revenue Code, sec. 404(a).


17. Internal Revenue Code, sec. 404(a).


19. With the limited exception that a deduction is permitted for a taxable year contribution made after the close of the taxable year but prior to the return filing date (including extensions). Internal Revenue Code, sec. 404(a)(6).

20. Treasury Regulations, sec. 1.404(b)-1.


24. Internal Revenue Code section 404(a) provides that employer contributions shall not be deductible under section 162 (relating to trade or business expenses) or section 212 (relating to expenses for the production of income); but, if they satisfy the conditions of either section, they shall be deductible under this section.

25. (Under the Tax Reform Act of 1986, the defined benefit dollar limit is adjusted annually for changes in the cost-of-living index.) The dollar limit for annual additions to defined contribution plans will remain at $30,000 and will not be increased for changes in the cost of living until the defined benefit plan limit exceeds $120,000 (Internal Revenue Code, sec. 415).


27. Internal Revenue Code, sec. 412.


29. Internal Revenue Code, secs. 409(a) and 4975(e)(7).

30. The term "annual addition" means the sum (for any year) of (1) employer contributions; (2) the employee's contribution; and (3) forfeitures. (Internal Revenue Code, sec. 415(c)(2)).

31. Internal Revenue Code, sec. 415(c).

32. Internal Revenue Code, sec. 404(a)(3).


34. The Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) actually set the combined-plan limit at 1.0 times the two limits separately. Because the separate fractions are computed differently from prior law, however, the effect is to generate the limits discussed in the text.
55 Internal Revenue Code, sec. 404(a)(7).
58 Revenue Act of 1942, sec. 23(p)(1)(D). Also see Treasury Regulations, secs. 1.404(a)-12(b)(2) and (c).
59 Internal Revenue Code, sec. 404(a)(5); Treasury Regulations, secs. 1.404(a)-12(b)(1).
60 Treasury Regulations, secs. 1.404(a)-12(c).
62 Treasury Regulations, secs. 1.404(a)-12(b)(2).
63 Internal Revenue Code, secs. 83(a) and 402(b).
64 The employee need not receive cash (or equivalent) compensation so long as the receipt of property from the employer in respect of services rendered confers an economic benefit on the employee. The value of an employer-purchased annuity was included in the employee’s gross income on receipt even though the annuity was not transferable and could not be surrendered for cash. See Brode v. Commissioner, 1 T.C. 275 (1942).
65 Treasury Regulations, sec. 1.451-2(a); In Deupree v. Commissioner, 1 T.C. 113 (1942), the president of a corporation was held to have constructively received the amount paid for an annuity policy for his benefit. The taxpayer had full discretion to take a cash payment, but directed the company to purchase the annuity instead.
66 As a rule of thumb, such contributions cannot exceed 6 percent of total compensation annually without Internal Revenue Service scrutiny, and even lower contribution levels may be deemed discriminatory. (Treasury Regulations, sec. 1.401-3(d); Revenue Ruling 80-307, 1980-2 C.B. 136.)
71 Prior to the Economic Recovery Tax Act of 1981, employees were taxed on amounts distributed or “made available” from a qualified plan. Section 314(c) of ERTA deleted reference to “made available.” See Internal Revenue Code, sec. 402(a)(1).
72 Internal Revenue Code, secs. 83(a) and 402(b).
73 Treasury Regulations, secs. 1.402(b)-1 and 1.83-3(c).
74 There are widespread reports that the growth of nonqualified plans has accelerated in response to legislation such as TEFRA and TRA.
75 Exempted plans include unfunded deferred compensation plans for highly compensated employees and excess benefit plans. See ERISA secs. 301-306, particularly secs. 301(a)(3) and (9).
76 Internal Revenue Code, sec. 402(a)(8).
77 Internal Revenue Code, sec. 408(b)(4).
78 Technically, contributions to Keogh plans are not employee contributions, since the self-employed individual is treated as an employer as well as an employee. In addition, the self-employed individual must make contributions to the plan on behalf of employees.
79 If the plan provides the employee with the option of receiving the amount as either a lump-sum distribution of benefits or an annuity in lieu of the lump sum, the employee must exercise the option to receive annuity payments within 60 days from the date when the lump sum first became payable or be treated as having constructively received the entire value (Internal Revenue Code, sec. 72(h); see also Revenue Ruling 59-94, 1959-1 C.B. 25).
80 In computing months of active participation before 1974, any part of a calendar year in which there was participation is counted as 12 months. When calculating months of participation after 1973, any part of a calendar month of participation is treated as one month.
81 Internal Revenue Code, secs. 402(a)(1)(A), (B) and 402(a)(2).
82 Internal Revenue Code, sec. 402(e).
83 Internal Revenue Code, sec. 402(e)(4)(I).
84 Internal Revenue Code, sec. 405(d)(1).
86 For purposes of this limit, all of an employer’s plans are treated as one.
The Employee Benefit Research Institute (EBRI) is a nonprofit, nonpartisan, public policy research organization based in Washington, DC. Established in 1978, EBRI provides educational and research materials to employers, employees, retired workers, public officials, members of the press, academics, and the general public. The Employee Benefit Research Institute Education and Research Fund (EBRI-ERF) is a nonprofit, nonpartisan education and research organization established by EBRI in 1979. EBRI-ERF produces and distributes a wide range of educational publications concerning health, welfare, and retirement policies. Through their books, policy forums, and monthly subscription service, EBRI and EBRI-ERF contribute to the formulation of effective and responsible health, welfare, and retirement policies. EBRI and EBRI-ERF have—and seek—a broad base of support among interested individuals and organizations, as well as among private-sector companies with interests in employee benefits education, research, and public policy.

EBRI Issue Brief and Employee Benefit Notes (a monthly newsletter featuring the latest news on legislation, corporate trends, statistics, events, and reviews in the field of employee benefits) are published by the Employee Benefit Research Institute Education and Research Fund with the assistance of the staff of the Employee Benefit Research Institute. Editorial inquiries may be directed to EBRI, 2121 K Street, NW, Suite 600, Washington, DC 20037-2121, (202) 659-0670. Orders, payments, inquiries, and all other correspondence relating to subscriptions should be sent to EBRI's distribution agent, The Johns Hopkins University Press, 701 W. 40th Street, Suite 275, Baltimore, MD 21211, USA, (301) 338-6964.

Nothing herein is to be construed as necessarily reflecting the views of the Employee Benefit Research Institute or the Employee Benefit Research Institute Education and Research Fund or as an attempt to aid or hinder the passage of any bill pending before Congress.

© 1988. Employee Benefit Research Institute. All rights reserved. ISSN: 0887-137X 0887-1388/88 $ .50 + .50

issue brief is registered in the U.S. Patent and Trademark Office.