Tax reform will force complete reappraisal of current employee benefit packages and a return to the basics.

Tax Reform and Employee Benefits

The recently enacted tax reform legislation makes dramatic changes in employee benefits both through the numerous provisions directly affecting benefits and through the overall reduction in individual income tax rates.

The changes in the pension and welfare benefit area are intended to produce more comparable employee benefit coverage of rank and file employees and of highly compensated employees. Pension changes, assuming that plans are maintained, increase the number of vested workers through faster vesting schedules, increase pension amounts for rank and file employees by limiting the coordination with Social Security benefits, and mandate broader and more comparable coverage of rank and file employees. Higher-paid employees, however, suffer potential losses in benefits: restrictions on 401(k) salary reduction contributions ($7,000 cap, tighter nondiscrimination rules, and inclusion of all after-tax contributions as annual additions under the section 415 limits); a new limit of $200,000 on the amount of compensation that may be taken into account under all qualified plans; a new excess benefit tax of 15 percent on most annual distributions over $112,500; and sharply reduced maximum benefits payable to early retirees under defined benefit plans. Changes in welfare benefit areas aim for the same effect: an intended broadening of benefits because of tighter nondiscrimination rules that also could reduce tax-favored benefits payable to the higher paid. Government staff have argued that reduced tax-favored benefits for the highly paid employees may be viewed as more comparable coverage of rank and file and highly paid when considered in terms of dollars, versus percent of compensation.

In all, the employee benefit changes are less punitive than those originally contained in the 1984 Treasury proposal. Favorable tax treatment is retained for most benefits, except education assistance, group legal services, and van pooling, which lose the income tax exclusion. Also, nondiscrimination rules for medical and group life insurance coverage are much more flexible than the original Treasury proposal, and permit a greater disparity between highly paid and rank and file employees.

Still, dramatic effects may be anticipated. The reduction in marginal tax rates will remove a significant force that historically contributed to the growth in employee benefits, and future growth will be slowed; coverage may not improve and may actually decline in the small business sector, where a top rate of 28 percent for the owners and a 15 percent rate for 80 percent of taxpayers may make cash more attractive than benefits, which are also more difficult to administer under the new rules. The desirability of deferring compensation for nonretirement purposes under qualified plans is also called into question, because of new penalties on early withdrawals and the expectation that future tax rates may be higher than current rates. Finally, because of the new restrictions on the higher-paid, many employers will face the option of removing the higher-paid from their general qualified benefit plans, which could result in deterioration in benefits for rank and file employees. As more of their compensation is provided through nonqualified plans, the higher compensated might "lose their stake" in the general benefit plan. Obviously, whether nondiscrimination rules cause expanded and more comparable coverage of rank and file employees, or reduce tax-favored benefits for the highly paid, will differ from employer to employer.

Employee benefits will remain an important piece of total compensation, but the changes in their tax effectiveness may prompt a reevaluation of overall benefits and a return to the basic purposes employee benefits were intended to fulfill: the promotion of economic security and human resource needs.
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Introduction

The March 1984 EBRI Issue Brief ("Basic Tax Reform: Implications for Employee Benefits") concluded with the following point: "Basic tax reform proposals would require employers and employees to rethink the entire basis of compensation." Final provisions of the Tax Reform Act of 1986 (TRAC) will require a reevaluation of trends in employee benefits of recent years. More specifically, with 80 percent of taxpayers at the 15 percent marginal bracket, tax savings can no longer be used as the driving motivation for establishing plans. Programs and plan design will have to be framed in terms of meeting economic security objectives in the most tax-effective manner, consistent with human resource needs and government intention. Or, as predicted in EBRI's January 1985 Issue Brief ("Tax Reform, Treasury Proposals, and Employee Benefits"), employee benefits and compensation planning will move "back to basics."

A move back to the basics is what government intends as it seeks to bring revenues and expenditures into balance at lower tax rates, make the tax code neutral to economic decisions unless there is a very good social reason not to, and target both expenditures and tax preferences much more narrowly than in the past. TRAC's employee benefit changes are projected by the Congress to increase federal revenues by $44.4 billion between 1987 and 1991 (table 1).

"Government intent" for employee benefit tax preferences can be interpreted with some precision from the provisions of TRAC and the series of proposals1 that led up to it:

1 Employee benefit tax incentives should be limited to those that offer a clear social purpose and provide protection against some risk.

(2) Coverage and nondiscrimination rules should be designed to assure that low- and middle-income employees actually benefit from plans.
(3) Benefits provided to the "highly compensated" on a tax-favored basis should be restricted to those provided to other employees (in the case of health and welfare plans) and by both dollar and percentage limits (in the case of retirement programs).
(4) Tax deductions for programs that are not subject to coverage and nondiscrimination rules, such as individual retirement accounts (IRAs), should not be available to "high" income taxpayers with pension coverage.
(5) Defined benefit and defined contribution programs should have a common primary purpose of delivering income at or near "normal" retirement ages and should not serve the purpose of short-term savings or an overriding purpose of encouraging early retirement.
(6) Defined benefit and defined contribution plans should always be a supplement to Social Security, and there should be absolute limits on the total amount of tax-favored retirement income that can be received from tax-favored plans.

TRAC shows that Congress is not yet prepared to accept arguments that executives base decisions regarding the sponsorship and design of tax-favored plans on what they can personally gain from them. Congress does not believe that limits on the "highly compensated" will lead to the "nonhighly compensated" getting less. Congress also does not believe that administrative complexity will hurt plan formation. By the end of 1989 plans will have been redesigned to conform to the provisions of TRAC, and data will be available to assess the accuracy of the congressional belief that TRAC provisions will help, not hurt.

A New Tax Structure with New Tax Rates

Basic Rate Structure

TRAC moves the individual tax rate structure from 15 brackets in 1986 to five in 1987 and two brackets in 1988. Table 2 shows the transitional rate structure for 1987.

The rate structure for 1988 and beyond builds upon two rates of 15 percent and 28 percent. Beginning in 1989 the taxable income amounts at which the 28 percent rate starts will be adjusted for inflation. (Taxable income equals adjusted gross income less personal exemptions and less the standard deduction or itemized deductions.) Table 3 shows the 1988...

---

### Table 1
Estimated Budget Effects of H.R. 3838, as Approved by the Conference Committee for Pensions and Deferred Compensation, Employee Benefits, and ESOPs
Fiscal Years 1987-1991
(millions of dollars)

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<td>Increase early retirement age</td>
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(continued on next page)
### Table 1 (continued)

**Estimated Budget Effects of H.R. 3838**

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<tr>
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<td>Individual</td>
<td>$ 3,141</td>
<td>$8,305</td>
<td>$9,058</td>
<td>$10,044</td>
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<td>50</td>
<td>585</td>
</tr>
<tr>
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<td>d</td>
<td>d</td>
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<td>TOTAL</td>
<td>$ 4,410</td>
<td>$ 9,336</td>
<td>$ 9,403</td>
<td>$ 10,204</td>
<td>$11,089</td>
<td>$44,442</td>
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</table>

Source: Joint Tax Committee

- Gain of less than $5 million.
- Amounts have not been assigned to footnotes for summation purposes. Therefore, totals do not include estimates represented by footnotes.
- Not yet effective.
- Exclusion expired.
- Loss of less than $5 million.
tax rate structure. A 33 percent rate is shown to reflect the phaseout of the 15 percent bracket for taxpayers having taxable income exceeding the specified levels. The income tax liability of such taxpayers is increased by 5 percent of their taxable income within the specified ranges (which will be adjusted for inflation beginning in 1989). It is significant for employee benefit planning that fully 80 percent of taxpayers are expected to be in the 15 percent bracket.

Changes are made in the standard deduction for 1987 and beyond that will serve to reduce the number of individuals

---

2 In 1987, for all individual taxpayers other than elderly or blind individuals, the standard deduction amounts are $3,760 for married individuals filing jointly and surviving spouses; $2,540 for heads of household and single individuals; and $1,880 for married individuals filing separately. For 1988, the respective amounts (indexed beginning in 1989) are $5,000 (married filing jointly and surviving spouses); $4,400 (heads of household); $3,000 (single individuals); and $2,500 (married filing separately).

itemizing deductions. The personal exemption is also increased. In addition, repeal of the special tax rate for long-term capital gains, the two-earner deduction, income averaging, the deduction for state and local sales taxes, and the phaseout of the deduction for consumer interest serves to increase the relative tax value of employee benefits. Finally, raising the threshold for medical deductions to 7.5 percent of adjusted gross income and introduction of a 2 percent deductibility of employee business expenses also serve to

---

Congress is not yet prepared to accept arguments that executives base decisions regarding sponsorship and design of tax-favored plans on what they can personally gain from them. Congress does not believe that limits on the "highly compensated" will lead to the "nonhighly compensated" getting less.

---

Table 2
1987 Transitional Individual Tax Rates

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<tr>
<th>Tax Rate</th>
<th>Married, Filing</th>
<th>Head of Household</th>
<th>Single</th>
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<td>Joint Return *</td>
<td></td>
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</tr>
<tr>
<td>11 %</td>
<td>$ 0 - $3,000</td>
<td>$ 0 - $2,500</td>
<td>0 - $1,800</td>
</tr>
<tr>
<td>15 %</td>
<td>$3,000 - $28,000</td>
<td>$2,500 - $23,000</td>
<td>$1,800 - 16,800</td>
</tr>
<tr>
<td>28 %</td>
<td>$28,000 - $45,000</td>
<td>$23,000 - $38,000</td>
<td>$16,800 - 27,000</td>
</tr>
<tr>
<td>35 %</td>
<td>$45,000 - $90,000</td>
<td>$38,000 - $80,000</td>
<td>$27,000 - 54,000</td>
</tr>
<tr>
<td>38.5%</td>
<td>Above $90,000</td>
<td>Above $80,000</td>
<td>Above $54,000</td>
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</table>

Source: Conference agreement for H.R. 3838.

*For married individuals filing separate returns in 1987, the taxable income bracket amounts begin at one-half the amounts for joint returns. The bracket amounts for surviving spouses are the same as those for married individuals filing joint returns.
increase the value of employer-provided benefits.

TRAC reduces the top corporate rate for 1988 from 46 percent to 34 percent (for income over $75,000), while imposing a strict 20 percent minimum tax. The corporate rate on the first $50,000 of corporate income will be 15 percent; 25 percent on income between $30,000 and $75,000. Benefit of the lower rates will be phased out for corporations earning over $100,000.

Implications of a New Basic Rate Structure

TRAC's lower tax rates will decrease the value to the individual of deferred compensation versus cash beginning in 1988. Individuals will also be encouraged to seek cash by the lower probability of being in a lower tax rate during retirement than in 1988, and by the prospect that rates may actually increase in the future. For those in the 15 percent bracket with enough career ahead of them to expect to move to the 28 percent bracket, and with the possibility of being in that bracket or a higher one during retirement, the cash versus deferral choice becomes far more difficult than under present law. Loss of the deduction for interest payments may also serve to increase employees' desire for cash or short-term savings and makes it more expensive to contribute to a plan through salary reduction and then borrow from that plan. Interest deduction limits also affect the value of business-owned life insurance, which may serve to reduce its attractiveness.3

A number of studies have been conducted in the past to assess the implications of reductions in marginal tax rates for the provision of employee benefits.4 These studies use different databases and suggest that a 10 percent reduction in marginal rates will reduce the portion of compensation taken in the form of benefits by between 2.2 percent to 20 percent. Reduction of the 50 percent marginal bracket to 33 percent

3 A deduction for interest on policyholder loans is not allowed in the case of loans aggregating more than $50,000 per officer, employee, or owner of an interest in any trade or business carried on by the taxpayer. The legislative history restates the present-law rules relating to the deduction for interest on loans incurred to carry or purchase single premium life insurance contracts, including a Senate floor colloquy relating to universal life insurance.

represents a reduction of 34 percent. (Some taxpayers, however, will not have any effective reduction in rates because of the base broadening in TRAC.) Where there is such a reduction of 34 percent, these studies would therefore indicate that the reduction in the share of compensation provided in the form of benefits could range under tax reform from 7.4 percent to 68 percent for maximum rate taxpayers; for other taxpayers the reduction would vary depending upon the size of the drop in their marginal tax rate.

The reduction in the value of the capital gains deduction (set at a maximum of 28 percent beginning in 1987) may increase employee interest in the use of qualified plans for investments involving capital gain. This could increase the proportion of employee-directed, defined contribution plan assets invested in equities.

Comments by House Ways and Means Chairman Dan Rostenkowski (D-IL) citing the need for higher tax rates in the future have been widely publicized. While tax rates may not rise during the Reagan era, continuing deficits will create pressure for a tax increase in the years ahead. If one were certain that tax rates would increase in the future, then income deferral during the period of lower rates would not prove to be the best strategy purely from a tax perspective. The value of "forced savings," however, should not be overlooked. Income taken in cash might put the individual ahead on taxes, but if the cash is spent and not saved, it will not help the individual enjoy a better income during retirement. Surveys indicate that employees value the forced-saving aspect of employer-sponsored plans.

Comparing After-Tax and Pretax Savings

An assessment of the relative advantage of tax-deferred savings under TRAC indicates why discretionary deferred compensation might drop significantly if programs are limited to employee dollars only; if taxes are the primary motivating force; and if short-term savings instead of retirement savings is the objective. When an employer match is introduced that will not be paid in cash if not "claimed" by an employee contribution, the employee will almost always be better off deferring. Charts 1 and 2 and table 4 present savings accumulations for the 15 percent bracket taxpayer with and without an employer match, for withdrawal before and after age 59 1/2. The comparison shows that for nonmatched deductible contributions, the deferral of tax results in a 5 percent gain over a regular savings account after five years if the withdrawal is after age 59 1/2. Were the withdrawal subject to the 10 percent early withdrawal additional income tax, the employee in the same situation would lose 7.3 percent compared to the regular savings account. A 50 percent match allows the employee to accumulate more, even in the event of an early withdrawal, gaining 39 percent (58 percent on a post-59 1/2 withdrawal). Charts 3 and 4 and table 5 make the same comparisons for an individual at the 28 percent rate. The comparison shows that for nonmatched deductible contributions, the deferral of tax results in a 10 percent gain over a regular savings account after five years, if the withdrawal is after age 59 1/2. Were the withdrawal subject to the 10 percent early withdrawal additional income tax, the employee in the same situation would lose 6 percent compared to the regular savings account. A 50 percent match allows the employee to accumulate more, even in the event of an early withdrawal, gaining 42 percent (64 percent on a post 59 1/2 withdrawal).

In general, the following observations can be made with regard to after-tax and pretax savings:

(1) Under most circumstances a matching contribution can be designed to assure that qualified plans produce a better retirement savings alternative than cash taken and saved.
(2) For individuals in the same tax bracket before and during retirement, with no employer match, a "perfect" tax-exempt bond could produce equal returns to a deferred account.
(3) For individuals who are certain that they will leave funds in a tax-deferred account until retirement and who expect to pay tax at no higher rate during retirement, a 401(k)-type deferral (i.e. deductible contribution) would be better than either a thrift/savings deferral (nondeductible contribution but interest deferred) or a fully taxable account.
(4) For individuals who will be in a lower tax bracket during retirement than when income is deferred, they can expect to accumulate more using a 401(k)-type deferral, with or without an employer match, than using any of the nondeferred options.
(5) For individuals who may be in a higher tax bracket either later in a career or during retirement, the length of the deferral period determines whether or not the deferral is better than regular savings.

This analysis represents a strong argument for the continued attractiveness of deferred savings intended for retirement and even short-term savings through those cash or deferred plans and thrift/savings plans that provide for an employer matching contribution. Furthermore, they present a strong case for
Chart 1
Savings Comparison for 15% Bracket Taxpayers With and Without 50% Employer Matching Contribution Early Withdrawal Lump-Sum

Note: Assumes $1,000 pretax contribution at 7% pretax rate of return, and early withdrawal subject to 10% additional tax.

Chart 2
Savings Comparison for 15% Bracket Taxpayers With and Without 50% Employer Matching Contribution Post-59 1/2 Lump-Sum

Note: Assumes $1,000 pretax contribution at 7% pretax rate of return, no income averaging or early withdrawal penalty.

Source: Employee Benefit Research Institute.
## Table 4

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<th>Nonded cont Int tax def 15% bkt</th>
<th>50% pre-tax e'er match</th>
<th>Match +cont Total 15% bkt</th>
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<td><strong>After 5 years</strong></td>
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<td>$701</td>
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<td>$1,192</td>
<td>$596</td>
<td>$1,788</td>
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**Assumptions:**
- Pretax withdrawal bracket: 15% 15%
- Retirement bracket: 15% 15%
- Early withdrawal penalty on deposit: 10% 10%
- Early withdrawal penalty on interest: 10% 10%
- 15% 15%

**Source:** Employee Benefit Research Institute.
Chart 3
Savings Comparison for 28% Bracket Taxpayers With and Without 50% Employer Matching Contribution Early Withdrawal Lump-Sum

Note: Assumes $1,000 pretax contribution at 7% pretax rate of return, and early withdrawal subject to 10% additional tax.

After: 5 years 10 years 15 years 20 years 30 years

- Ded. contribution
- Ded. cont. w/match
- Noned. contribution
- Noned. cont. w/match
- Regular savings
- Tax-exempt bond

Source: Employee Benefit Research Institute.

Chart 4
Savings Comparison for 28% Bracket Taxpayers With and Without 50% Employer Matching Contribution Post-59 1/2 Lump-Sum

Note: Assumes $1,000 pretax contribution at 7% pretax rate of return, no income averaging or early withdrawal penalty.

After: 5 years 10 years 15 years 20 years 30 years

- Ded. contribution
- Ded. cont. w/match
- Noned. contribution
- Noned. cont. w/match
- Regular savings
- Tax-exempt bond

Source: Employee Benefit Research Institute.
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Assumptions:
- Preretirement bracket: 28% 28% 28% 28% 28% 28%
- Retirement bracket: 28% 28% 28% 28% 28% 28%
- Early withdrawal penalty on deposit: 10% 10% 0% 10% 0% 0%
- Early withdrawal penalty on interest: 10% 10% 10% 10% 0% 0%

Source: Employee Benefit Research Institute.
employee contributions to these matched plans rather than to an IRA. Over 95 percent of 401(k) plan participants should have room within the new $7,000 limit to make full use of these plans. IRAs appear to be relatively unattractive unless funds are left in the IRA for a minimum of 15 years or until age 59 1/2. Most employers should also be able to offer employees a greater rate of return through the employer plan than the employee could achieve through IRA shopping.

- Contributions to and Distributions from Qualified Plans

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Table 6
Change in Section 415 Limits for Maximum Early Retirement Benefits Payable under a Defined Benefit Pension Plan

Source: Actuarial Sciences Associates.
cutbacks in benefits, but it is argued that fewer enhancements will be provided so that real benefit values will decline significantly over time.

Example 1: Suppose the top executives of a company find that 20 percent of their pension will be paid from the defined benefit plan and 80 percent from a nonqualified company plan payable only if the company remains in business and has funds available. The executives may become most concerned with the strength of the business to the detriment of the plan. This could influence decisions made with regard to the qualified plan. For example, if the question arises: "Should an asset reversion be taken from the plan to 'strengthen' the business?" The answer might be "Yes." But, were these same executives looking to the qualified defined benefit plan for 100 percent of their pension, the asset reversion decision would become much more difficult one if there were any prospect that it might be to the long-term detriment of the plan.

Example 2: Suppose defined benefit plan 415 limits were again frozen in 1988 and were held frozen for 10 years, while salaries increase at 8 percent per year. The executive who was at the maximum benefit in 1988 would see more and more of the total benefit coming from a direct employer unfunded commitment ("nonqualified plan"). Does the executive have any direct interest in increasing benefits under the defined benefit plan? No.

Includible Compensation

A new limit for most plans on includible compensation will have the effect of isolating a greater portion of executives' benefit expectations from those of the rank and file. TRAC imposes a limit of $200,000 on the amount of compensation that can be used to determine allowable contributions and benefits, and for the nondiscrimination rules, on all qualified plans beginning in 1989. Under current law this limit only applies to top-heavy plans and SEPs. The $200,000 limit will be indexed to track the defined benefit plan limit beginning in 1990. The conference also clarify that, with respect to a defined benefit pension plan, the $200,000 limit applies to each year's compensation (including years prior to 1989), not solely to the final average or career average compensation of an individual.

Tax Deferral under Qualified Plans

For the present, dollar limits under section 415—the lesser of $30,000 or 25 percent of compensation for annual additions to defined contribution plans, and $90,000 for defined benefit plans—along with combined plan limits, have been retained. Under TRAC an employer's contribution to a profit sharing plan for plan years beginning after December 31, 1985, is not limited to the employer's current or accumulated profits (this provision applies without regard to whether the employer is tax-exempt). Other significant changes have been made, however.

Indexation of Limits—TRAC changes the relationship of plans by holding the defined contribution limit at $30,000 until the defined benefit plan limit, which will be indexed beginning in 1988, has increased to $120,000. This change of ratio from 3:1 ($90,000 to $30,000) to 4:1 ($120,000 to $30,000) will then be maintained in the future. At 5 percent inflation, the defined contribution limit would be frozen until 1994. This change explicitly attempts to increase the relative attractiveness of defined benefit plans. As a result of the other changes discussed in this section, however, it is open to question whether this objective will be realized.

Tightening the 25 Percent Limitation—TRAC tightens the defined contribution limit further by requiring that all after-tax employee contributions be counted as part of the permissible annual addition (i.e., whether or not such contributions exceed 6 percent of pay). The 25 percent combined plan deduction limit is extended to any combination of a defined benefit pension plan and a money purchase pension plan, profit sharing, or stock bonus plan. TRAC clarifies that contributions made by retired nonkey employees for retiree medical coverage are not subject to the 25 percent of compensation limit on annual additions. Generally these provisions are effective for taxable years beginning after December 31, 1986 (later for collectively bargained plans).

Reducing Allowable Early Retirement Benefits—The $75,000 floor for defined benefit plan early retirement benefits is eliminated by TRAC (generally for years beginning after December 31, 1986) so that the maximum benefit amount will be reduced for all benefits paid before the legally specified normal retirement age under Social Security. Benefits accrued prior to December 31, 1986, are grandfathered under TRAC, with the reductions applicable to future accruals. For those born before 1938 the age is 65, but as a result of the Social Security Act Amendments of 1983 it increases to 66 for those born between 1938 and 1954 and rises to age 67 for those born after 1954. The changes do not affect plans maintained by tax-exempt employers, and therefore exclude government
employees from these provisions. The reduced dollar limit on annual benefits under a qualified defined benefit pension plan is phased-in over 10 years of participation, rather than years of service provided for in current law, but an exception may be made for certain benefit increases as determined by regulations.

Special rules are provided for commercial airline pilots and participants in a qualified police or firefighters' defined benefit pension plan. The definition of a qualified police or firefighters' plan is clarified and indexing of the limit applicable under the special rules for those plans is provided for.

Elimination of the $75,000 floor is viewed by most observers as having been included in the bill in order to raise revenue—$4.5 billion over five years. Some, however, see a policy reason for the action. The House Select Committee on Aging, for example, in releasing a recent GAO report, has called for actions that would reduce incentives to early retirement and encourage individuals to work longer. Elimination of the floor can be viewed as an effort by the Congress to encourage individuals to work longer by denying tax incentives that serve to explicitly encourage early retirement through unreduced benefits. This would not be the first time that a policy change was "sold" for revenue reasons even though some had broader objectives in mind. Regardless of the motivation, the effect will be to discourage early retirement. Government staff have pointed out, however, that the $75,000 floor was not indexed under current law, so it would have become irrelevant after 10 or more years of indexation of the $90,000 defined benefit limit. TRAC, in their view, eliminated what was essentially a TEFRA transition rule. Table 6 shows how dramatic the impact of this change is.

**Imposition of Excise Taxes on Distributions above $112,500**—To meet an objective of limiting the extent to which tax-favored benefits can be used to "excessively" supplement Social Security, TRAC imposes a 15 percent excise tax on aggregate annual distributions (excluding basis recovery and rolled-over amounts) to an individual exceeding 1.25 percent of the indexed defined benefit plan benefit limit, $112,500 in 1987. In any year the benefits from all tax-favored plans (including IRAs) must be included. Under a complicated transition rule, the tax either will not apply to "excess" benefits accrued before August 1, 1986, or the applicable dollar threshold will be increased to $150,000. The annual 15 percent tax will not apply to postdeath distributions, but there will be a comparable estate tax.

The $112,500 ceiling will not be adjusted to reflect the age at which payments commence, and the 15 percent tax will be reduced to the extent that a distribution is subject to the 10 percent tax on early distributions. The 15 percent tax also will not apply to distributions for which a rollover contribution is made, or which represent a nontaxable return of employee contributions.

A higher ceiling will apply for purposes of calculating the excess distribution in any year in which an employee receives a lump-sum distribution that is taxed under long-term capital gains or five-year forward averaging. The higher ceiling is the lesser of (1) the portion of the lump-sum distribution that is taxed under the favorable rules or (2) five times the otherwise applicable limit. Also, the 15 percent tax applies separately to the lump sum, so that other distributions (e.g., annuity payments from a defined benefit plan) are subject to a separate

$12,500/$150,000 limit.

**Cost-of-Living Arrangements**—TRAC permits a defined benefit pension plan to maintain a qualified cost-of-living arrangement under which employer and employee contributions may be applied to provide cost-of-living increases to the primary benefit under the plan. If an arrangement qualifies, an employee contribution under the arrangement will not be treated as an annual addition in applying the separate limit on additions under defined contribution plans, but will be treated as an annual addition for purposes of applying the combined plan limit (section 415(e)). Furthermore, under a qualified arrangement, the benefit attributable to an employee's contribution will be treated as a benefit derived from employer contributions for purposes of the limit on annual benefits. A qualified cost-of-living arrangement is required to comply with the dollar limits, election procedures, and nondiscrimination
requirements of TRAC. In addition, the right to the employer-derived portion of a qualified cost-of-living benefit is part of an employee's accrued benefit subject to vesting and benefit accrual requirements and the prohibition on retroactive reductions in accrued benefits, and is to be treated under rules similar to rules for employer-derived early retirement benefits.

Deductions for Contributions—The limit carryforward applicable to profit sharing and stock bonus plans is repealed, and a 10 percent excise tax is applied to nondeductible employer contributions. The law includes a technical modification relating to fully insured plans (effective for taxable years after 12/31/86).

Excise Tax on Reversion of Qualified Plan Assets to Employer—TRAC imposes a 10 percent nondeductible excise tax on a reversion from a qualified plan. The tax is imposed on the employer receiving the reversion. The agreement also provides that the tax does not apply to the portion of a reversion that is transferred to an ESOP under certain circumstances. The provision applies to reversions attributable to plan terminations received on or after January 1, 1986. The special provision for transfers to an ESOP expires for reversions due to termination which occurs after December 31, 1988, or other reversions received after December 31, 1988. Some observers believe that this date will be extended, but the retirement of Senator Russell Long (D-LA)—the champion of ESOPs—may actually cause tax law reenforcement to ESOPs in a future Congress.

Uniform Commencement Date for Benefits—TRAC establishes a uniform commencement date for benefits under all qualified plans, IRAs, tax-sheltered annuities, custodial accounts, and unfunded deferred compensation plans of state and local government and tax-exempt employers. Distributions must commence no later than April 1 of the calendar year following the calendar year in which the participant or owner attains age 70 1/2, without regard to the actual date of retirement. TRAC establishes a new sanction, in lieu of plan disqualification, in the form of a 50 percent excise tax for failure to satisfy the minimum distribution rules. These provisions generally apply to distributions made after December 31, 1988.

Treatment of Distributions—TRAC (1) phases out capital gains treatment for lump-sum distributions over six years beginning on January 1, 1987; and (2) eliminates 10-year forward averaging for taxable years beginning after December 31, 1986, and instead, permits a one-time election of five-year forward averaging for a lump-sum distribution received after attainment of 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 five-year forward averaging or 10-year forward averaging (at present-law 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.

The effect of the replacement of 10-year forward averaging with five-year averaging can represent a significant increase in tax paid. For example, assuming a $200,000 distribution under current law, total tax would be $32,050. Under TRAC and five-year averaging the same $200,000 distribution would have a tax of $56,000. A distribution of $89,245 or less would allow payment at the 15 percent bracket, while a distribution in excess of $215,750 would become subject to the 5 percent surcharge and would thus be taxed at a 33 percent rate, eliminating any potential value of averaging. The one-time election of the averaging provision also represents a major change. This change ends the ability to use the special treatment at each job change with the result of very low tax rates over time.

TRAC (1) modifies the present-law basis recovery rules for amounts distributed prior to a participant's annuity starting date to provide for pro rata recovery of employee contributions; (2) eliminates the special three-year basis recovery rule of present law; (3) modifies the general basis recovery rules for amounts paid as an annuity to provide that each distribution is treated in part as recovery of employee contributions and in part as payment of taxable employer contributions (until all employee contributions are recovered); and (4) restricts rollovers of partial distributions to distributions due to separation from service.

The new basis recovery rules do not apply to employee contributions made prior to January 1, 1987, to the extent that, on May 5, 1986, such contributions were available for distribution under a plan before separation of service. This means that these employee contributions to 401(a) plans will be able to be withdrawn without being subjected to pro rata taxation.

The new preannuity starting date basis recovery rule and the new restrictions on rollovers of partial distributions are generally effective with respect to distributions made after
December 31, 1986, with a provision preventing avoidance of repeal of the three-year basis recovery rule. The repeal of the three-year basis recovery rules is generally effective with respect to individuals whose annuity starting date is after July 1, 1986, except for repeal of the special three-year basis recovery rule which is generally effective after January 1, 1988. For contributory defined benefit plans, however, three-year basis recovery is repealed effective July 1, 1986.

Basis recovery rules (effective January 1, 1987) are also established for distributions from an IRA to which nondeductible contributions have been made, and rollovers from frozen deposits in bankrupt or insolvent savings and loan associations will be allowed after the 60-day rollover election period.

The changes in distributions represent a major change for employers that have maintained any plan that includes after-tax employee contributions. While most publicity has focused on government employees, the thousands of employers with thrift/savings plans will face a significant challenge in communicating the changes and, once the provisions are understood, in maintaining nondiscriminatory employee participation in the plan.

TRAC also includes a "separate contract rule" that applies to plans accepting both pretax and after-tax contributions. The rule allows the employee's after-tax contributions, and earnings on those contributions, to be treated as a separate "plan" for purposes of the pro rata rule. Thus, only the percentage represented by earnings on the after-tax contribution would be taxable. The value of pretax contributions and earnings attributable to them would not be included in the pro rata calculation. This may, to some degree, offset the other disincentives to after-tax contributions.

**Taxation of Early Distributions**—TRAC provides significant penalties for most early distributions from qualified retirement plans. It applies a 10 percent additional income tax to all early distributions includible in gross income, regardless of the character of the contribution to which the distribution relates, from a qualified plan, qualified annuity plan, tax-sheltered annuity, or IRA, made before death, disability, or attainment of age 59 1/2 in taxable years beginning after December 31, 1986; but it does not apply to sec. 457 plans.

The 10 percent additional tax does not apply to certain distributions (1) in the form of an annuity payable over the life or life expectancy of the participant (or the joint lives or life expectancy of the participant and the participant's beneficiary); (2) made after the participant has attained age 55, separated from service, and satisfied the conditions for early retirement under the plan; (3) used for payment of medical expenses to the extent deductible under sec. 213; (4) received from an ESOP before January 1, 1990; (5) received in a lump sum prior to March 15, 1987, if made on account of separation from service in 1986 if the recipient elects to be taxed on the distribution in 1986; or (6) made to or on the behalf of an alternate payee pursuant to a qualified domestic relations order.

**Tax-Sheltered Annuities**—TRAC extends the withdrawal restrictions currently applicable to tax-sheltered custodial accounts to elective contributions made to a tax-sheltered annuity. Also, withdrawals on account of hardship from a custodial account or other tax-sheltered annuities (TSAs) are permitted only to the extent of contributions made pursuant to a salary reduction agreement (but not earnings on those contributions), effective for years beginning after December 31, 1986.

**Loans under Qualified Plans**—TRAC also modifies the rules relating to the tax treatment of loans under qualified plans for amounts received as a loan after December 31, 1985 by (1) limiting the ability of plan participants to maintain permanent loan balances by reducing loans in the current year by the highest balance in the previous 12 months; (2) limiting the availability of the extended repayment period for loans for principal residences to loans applied to the purchase of the participant's principal residence; (3) requiring level amortization of a loan over the permissible repayment period; and (4) denying interest deduction for repayment of loans by key employees and for all employees with respect to 401(k) contributions. The amount of the nondeductible interest, however, would reduce the employee's taxable basis in the plan.

**Tax-Favored Savings**

**Individual Retirement Accounts (IRAs)**

**Deductible IRAs**—TRAC retains the full $2,000 deductible IRA contribution as permitted under present law (1) if an individual (or a married couple) has adjusted gross income (AGI) under a phaseout level; or (2) if the individual is not an active participant (or, in the case of a married individual, neither the individual nor his or her spouse is an active...
participant) in an employer-maintained retirement plan for any part of the plan year ending with or within the individual's taxable year. The phaseout begins at $25,000 (AGI) for an individual and $40,000 (AGI) for a married couple filing a joint return. For purposes of the phaseout, AGI is determined without regard to any IRA contributions.

For an individual who is an active participant in an employer-maintained retirement plan, the IRA deduction limit is reduced proportionately for AGI between $25,000 and $35,000. For married couples filing a joint return, the IRA deduction limit for each spouse is reduced proportionately for AGI between $40,000 and $50,000, if either spouse is an active participant in an employer-maintained retirement plan. For married couples filing separately, the IRA deduction limit is reduced proportionately for AGI between $0 and $10,000.

This analysis represents a strong argument for the continued attractiveness of deferred savings intended for retirement and even short-term savings through those cash or deferred plans and thrift/savings plans that provide for an employer matching contribution. Furthermore, they present a strong case for employee contributions to these matched plans rather than to an IRA. Over 95 percent of 401(k) plan participants should have room within the new $7,000 limit to make full use of these plans. IRAs appear to be relatively unattractive unless funds are left in the IRA for a minimum of 15 years or until age 59 1/2. Most employers should also be able to offer employees a greater rate of return through the employer plan than the employee could achieve through IRA shopping.

An estimated 24.4 million individuals had opened an IRA by the end of 1985, EBRI estimates.

Analysis of Current Population Survey data provides a basis for estimates of impact. EBRI estimates that among all single taxpayers nearly 93 percent would have been unaffected had TRAC been effective in 1985; less than 2 percent would have been denied a deductible IRA; and approximately 5 percent would only have been eligible for a partial deduction. About 3 million single taxpayers would have lost all or part of the IRA deduction. This leaves more than 36 million single taxpayers who would have been eligible for a full IRA deduction.

Among married taxpaying units, the numbers for those who would have been adversely affected are higher due to higher pension coverage among married individuals at all income levels. For married couples—had TRAC been in effect in 1985—just over 7 percent would have lost the ability to make a tax deductible IRA contribution, and another 7 percent would have been allowed only a partial deduction. Together this represents over 7 million additional taxpaying units. An estimated 41 million married taxpaying units would have remained eligible for a full IRA deduction.

Among the estimated 24.4 million individuals who had opened an IRA by the end of 1985, EBRI estimates that 15 percent (3.7 million) would have lost the IRA deduction, 12 percent (2.9 million) would have been eligible for a partial deduction, and an estimated 73 percent (17.8 million) would have been eligible for a full deduction if TRAC had been in effect in 1985. Based upon average IRA contribution data from the CPS and the IRS, EBRI estimates that pre-tax IRA contributions might have fallen by $10.3 billion in 1985 just
due to the change in availability. Further reductions might result from the lower tax rates under tax reform, which diminish the tax value of a deductible contribution.

**Nondeductible IRAs**—TRAC provides that individuals may make nondeductible IRA contributions to the extent that they are not eligible to make deductible IRA contributions. Earnings on nondeductible IRA contributions are not subject to tax until they are withdrawn, but when withdrawn the pro rata basis recovery rule applies.

The numbers presented above indicate that approximately 10 million taxpayers are eligible to use the nondeductible IRA for some contribution amount.

**Spousal IRAs**—Under TRAC, the rules relating to spousal IRA contributions are amended to eliminate the requirement that the spouse have no earned income for the year in order to be eligible for the spousal IRA contribution.

**Investment of IRAs**—TRAC also amends present law to permit the acquisition by IRAs of certain gold and silver coins issued by the United States.

**IRA Effective Dates**—The provisions are effective for taxable years beginning after December 31, 1986, except that the provision eliminating the requirement that the spouse have no earned income to be eligible for the spousal IRA contribution is effective for years beginning after December 31, 1985.

**Qualified Cash or Deferred Arrangements**

**Limits on Contributions**—Elective deferrals to a 401(k) plan would be limited to $7,000 per calendar year and would be coordinated with elective contributions to simplified employee pensions (SEPs), state and local government plans (section 457 plans), tax-sheltered annuities (section 403(b) plans) and section 501(c)(18) trusts. The new limit would apply on a pro rata basis to partnerships fiscal years ending in 1987. The $7,000 cap is adjusted for inflation by reference to percentage increases in the dollar limit under a defined benefit plan (sec. 415(d)) beginning in 1988.

If for any calendar year an employee's elective contributions total more than $7,000, the excess (and any income thereon) would be included in the employee's gross income for the year. The income on the excess contribution would be allocated on a pro rata basis. Any excess contribution distributed to an employee by April 15 following the close of the tax year in which the excess deferral was made would not be subject to the penalty tax on early withdrawals. Excess contributions not returned by April 15 could not be distributed other than in accordance with 401(k) distribution rules. Also, even though included in the employee's income, the employee would have no basis in the excess.

Employers and employees will be required to report all voluntary income deferrals beginning in 1987 under TRAC (new section 402(g)(3)), and it is likely that a new box on W-2 forms will be added for this purpose.

These provisions would be effective for taxable years beginning after December 31, 1986, except for certain collectively bargained plans, which would have effective dates beginning on or after the earlier of (1) termination of a collective bargaining agreement or (2) January 1, 1991. Many of the deferred effective dates for union plans (including this one) apply only to represented employees; this later date does not apply to nonrepresented employees in the union plan.

EBRI estimates that approximately 1 million of the 10 million taxpayers units ineligible to make a full deductible IRA contribution are participating in 401(k) plans and might be able to contribute a portion of the denied IRA dollars to the 401(k) plan. Mere eligibility in 401(k) is not considered "active participation." Making an actual elective 401(k) contribution is considered "active participation."

**401(k) Nondiscrimination Requirements**—The 401(k) nondiscrimination test would be satisfied if the actual deferral for the highly compensated employees does not exceed the greater of: 1) 125 percent of the actual deferral percentage for all other eligible employees; or (2) the lesser of (a) 200 percent of the actual deferral percentage for all other eligible employees or (b) such actual deferral percentage plus 2 percentage points.

Highly compensated employees would be those employees defined as such under the uniform definition used generally for the nondiscrimination rules applicable to qualified plans and employee benefit programs (described below). A uniform definition of compensation (generally, includible compensation) is specified.

To satisfy the nondiscrimination requirements in any year, an employer may distribute participants' contributions (plus income allocable to such contributions) that are in excess of those required to satisfy nondiscrimination rules by the end of
the following plan year and remain a qualified plan. Contributions distributed to participants by employers to satisfy nondiscrimination requirements would not be subject to a penalty tax on early withdrawals, and income from these distributions would be allocated on a pro rata basis. But, if a distribution is not made within 2 1/2 months after the end of the plan year, there is a 10 percent tax on the employer. Cash outs would be permitted without regard to plan provisions until the required plan amendment date.

These provisions would generally be effective for years beginning after December 31, 1986, except in the case of collectively bargained plan agreements ratified before March 1, 1986. In these latter plans, the amendments are not effective, with respect to employees covered by the collective bargaining agreement, for plan years beginning before the earlier of (1) January 1, 1989; or (2) the date on which the last of the collective bargaining agreement terminates (determined without regard to any extensions in the agreement). For grandfathered plans of state and local government employers (see below), nondiscrimination provisions would be effective beginning January 1, 1989.

Hardship Withdrawals and Other Distributions—Hardship withdrawals under 401(k) plans would be limited to an employee's elective deferrals (but not income thereon). Withdrawals on account of plan termination or sale of a subsidiary would be permitted for distributions occurring after December 31, 1984. All withdrawals before age 59 1/2 would be subject to a 10 percent additional tax unless they fall under one of the specific categories named as exceptions to the additional tax (see "Taxation of Early Distributions" above). An employer may not condition contributions or benefits to other plans on an employee's participation in a 401(k) plan. These provisions are effective for years beginning after December 31, 1988. "Qualified offset" plans in existence on April 16, 1986, are exempt from this rule.

Participation—A qualified cash or deferred arrangement cannot require as a condition of participation in the arrangement that an employee complete a period of service with the employer (or employers) maintaining the plan in excess of one year of service, effective for years beginning after December 31, 1988.

Tax-Exempt and State and Local Government Employers—401(k) plans would not be available to tax-exempt and state and local government employers. Tax-exempt employer plans adopted before July 2, 1986, and state and local government plans adopted before May 6, 1986, would be grandfathered.

Employer Matching Contributions and Employee Contributions

A special nondiscrimination test is applied to employer matching contributions and employee contributions under all qualified defined contribution plans and employee contributions under a defined benefit plan (to the extent allocated to a separate account on behalf of the employee). This test is similar to the special nondiscrimination test applicable to qualified cash or deferred arrangements.

The nondiscrimination test is satisfied for a plan year if the contribution percentage for highly compensated employees does not exceed the greater of (1) 125 percent of the contribution percentage for all other eligible employees; or (2) the lesser of 200 percent of the contribution percentage for all other eligible employees or such percentage plus 2 percentage points. The contribution percentage for a group of employees for a plan year is the average of the ratios (calculated separately for each employee in the group) of the sum of matching and employee contributions on behalf of each such employee to the employee's compensation for the year.

The definition of highly compensated employees would be adopted for uniform usage, and a uniform definition of compensation would be adopted.

Excess contributions distributed to participants would not disqualify the plan if they were distributed to participants no later than the end of the plan year following the year in which the contributions were made. A 10 percent penalty tax would be applied to distributions unless distributed within 2 1/2 months after the end of the year in which the contributions were made. This same rule also applies to elective 401(k) contributions. Income on these excess contributions would be allocated on a pro rata basis. The treatment of employee contributions to contributory defined benefit plans would be clarified.

Unfunded Deferred Compensation Arrangements (Section 457 Plans) for Tax-Exempt Employers

Nongovernmental tax-exempt organizations could make use of unfunded deferred compensation plans (section 457 plans) beginning in 1987. The maximum annual contribution that an employee may defer from salary is the lesser of (1) $7,500 or (2) 33 1/3 percent of compensation (net of deferral). In addition, contributions to these plans would be reduced dollar-
for-dollar for contributions to a 401(k) plan (except a 401(k) plan maintained by a rural electric cooperative), 403(b) plan, SEP, or 501(c)(18) trust. Government staff suggest that this change in the law was made so that section 457 would act as a limit on nonqualified deferred compensation by the highly paid. Tax-exempt employers are not exempt from the Employee Retirement Income Security Act of 1974 (ERISA) Title 1, and thus cannot maintain a broad-based unfunded section 457 plan.

Distributions after December 31, 1988, are required (1) to satisfy a payout schedule under which benefits projected to be paid over the lifetime of the participant are at least 66 2/3 percent of the total benefits payable with respect to the participant; and (2) in the case of benefits payable over a period of more than one year, to be paid on a substantially nonincreasing basis, and after the death of the employee, to provide for the commencement of benefits to the employee's beneficiary within one year after the employee's death.

Distributions must commence by April 1 of the taxable year in which participant attains age 70 1/2. A 50 percent excise tax would be applicable upon failure to distribute timely.

Deferred Annuity Contracts

Effective for years beginning after December 31, 1986, if a deferred annuity contract is held by a person who is not a natural person (e.g., a corporation or a trust), then the contract is not treated as an annuity contract for federal income tax purposes and the investment income on the contract for any taxable year is treated as ordinary income received or accrued by the owner of the contract during the taxable year. An exemption from the rule is provided for qualified funding assets purchased by structured settlement companies and annuities held by an employer with respect to a terminated pension plan.

In addition, TRAC increases the early withdrawal tax to 10 percent from 5 percent, and it modifies the circumstances under which the additional income tax on early withdrawals from deferred annuity contracts will be imposed to conform generally to the circumstances under which the early withdrawal tax is imposed under qualified plans.

Tax-Sponsored Annuities—Elective deferrals to all tax-sheltered annuities (sec. 403(b)) would be limited beginning in 1987 to $9,500. The $9,500 will be indexed when the $7,000 on elective deferrals under a 401(k) plan reaches $9,500, and, 401(k) elective deferrals count against the $9,500 limit. A special catch-up election is provided. Certain classes of employers (such as educational associations, hospitals, home health service agencies, churches, or a convention or association of churches) may contribute in excess of usual percentage limits in certain years. The class of employers whose employees are entitled to the special catch-up elections under existing section 415 catch ups is expanded to include employers that are health and welfare service agencies (catch-up rules apply before separation from service). TRAC also adds a new catch up for elective deferrals to 403(b) annuities. It provides that an eligible employee who has completed 15 years of service may make additional contributions of up to $3,000 annually beyond the $7,000/$9,500 limit, subject to certain aggregate annual and lifetime limits.

Simplified Employee Pensions

An employer with 25 or fewer employees is permitted to maintain a salary reduction SEP if at least 50 percent of employees elect to participate, effective for years beginning after December 31, 1986. Salary reduction contributions permitted under such a SEP are limited to $7,000 and coordinated with contributions to an employer's 401(k) plan, 457 plan, 403(b) plan, and 501(c)(18) trust.

Under tax reform, tax savings can no longer be used as the driving motivation for establishing plans.

An employer maintaining a SEP must make contributions for all employees who have (1) attained age 21 (reduced from age 25); (2) performed services for the employer during at least three of the immediately preceding five years; and (3) received at least $300 in compensation from the employer for the year.

The average amount deferred as a percentage of compensation for each highly compensated employee is limited to no more than 125 percent of the average deferral percentage of all other eligible nonhighly paid employees. Nonelective employer contributions would continue to be subject to the nondiscrimination rules of current law. Highly compensated employees are defined under the same rules as for 401(k) plans.

A SEP may be maintained under a fiscal-year basis, rather than a calendar-year basis.
Section 501(c)(18) Plans

Effective for years beginning after December 31, 1986, elective contributions are deductible up to the lesser of $7,000 or 25 percent of the compensation of the employee includible in income for the taxable year. The limit is reduced dollar-for-dollar for contributions to 401(k) plans and SEPS. A 501(c)(18) plan must satisfy a nondiscrimination test similar to that required for 401(k) plans. Excess contributions are treated in a similar manner to rules applicable to excess contributions under a 401(k) plan.

Nondiscrimination Requirements for Qualified Plans

Minimum Coverage Rules for Qualified Plans

Under present law, a qualified plan is required to cover employees in general rather than merely the employees who are officers, shareholders, or highly compensated. A plan generally satisfies the present-law coverage rule if (1) it benefits a certain percentage of the employer's work force (percentage test of 56 to 70 percent); or (2) it benefits a classification of employees determined by the Secretary of the Treasury not to discriminate in favor of employees who are officers, shareholders, or highly compensated (classification test).

TRAC provides new coverage rules for qualified plans. They require that one of the following tests be satisfied:

1. Seventy percent of all nonhighly compensated employees are covered by the plan.
2. The percentage of nonhighly compensated employees covered by the plan is at least 70 percent of the percentage of highly compensated employees covered.
3. The group of employees covered by the plan satisfies the present-law classification test, and the average benefit provided to all nonhighly compensated employees (as a percentage of compensation), including those not covered by the plan, is at least 70 percent of the average benefit provided to highly compensated employees (as a percentage of compensation), including those not covered by the plan.

In applying the third test, elective deferrals under a qualified cash or deferred arrangement would be taken into account. This has been criticized by some observers as requiring these plans to be included in two sets of nondiscrimination requirements. And, they have provided examples of cases in which inclusion of the CODA could have the effect of causing an otherwise nondiscriminatory plan to be viewed as failing the test. As a result, one of the plans would have to be modified (such as reducing elective deferrals for highly compensated employees under the section 401(k) plan) or face disqualification.

A minimum of 20,000 employers have multiple qualified retirement and capital accumulation plans. With the growth of CODA plans, this now includes nearly every large employer, including the federal government. Some of these employers will have to meet the third test noted above, with possible failure of the test.

In addition, TRAC (1) clarifies the circumstances under which an employee will be treated as benefiting under a plan for purposes of the coverage rules; (2) modifies, for purposes of satisfying the new coverage requirements, the circumstances under which certain categories of employees may be excluded from consideration; (3) establishes a uniform objective definition of those employees in whose favor discriminatory coverage is prohibited; (4) permits satisfaction of certain of the coverage rules on a controlled group or line of business basis; (5) establishes a definition of a separate line of business or operating unit with a special safe harbor rule; and (6) contains a special transition rule for certain dispositions or acquisitions of a business.

The provisions are generally effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

The new coverage tests will present special challenges to employers providing salaried-only type plans. Many will find it difficult to pass the 70 percent average benefit test. Many employers will either increase automatic contributions or plan benefit formulas, or reduce what is provided to the highly compensated. Others may be forced to do what Congress really sought with this provision: cover 90 to 100 percent of their employees.

Minimum Participation Rule

Under TRAC, a plan would not be a qualified plan unless it benefits no fewer than the lesser of (1) 50 employees or (2) 40 percent or more of all employees of the employer. The requirement may not be satisfied by aggregating comparable plans. In the case of a cash or deferred arrangement or the
portion of a defined contribution plan to which employee contributions or employer matching contributions are made, an employee would be treated as benefiting under the plan if the employee was eligible to make contributions to the plan.

For purposes of applying the minimum participation rules, the same categories of employees may be disregarded as may be disregarded for purposes of applying the general coverage rules. In the case of a plan covering only employees included in a unit of employees covered by a collective bargaining agreement, all employees not included in such units may be disregarded for purposes of satisfying the minimum participation rule.

A transition rule provides that (1) plans that do not comply with the minimum participation rule must be merged or terminated by the beginning of the first plan year to which the rule applies (i.e., plan years beginning after 12/31/88); (2) the excise tax on asset reversions would not apply to such a termination or merger; and (3) the present value of accrued benefits must be calculated using an interest rate no lower than a specified rate.

The definition of a "plan" for purposes of the rule would be clarified. Multiemployer plans are exempt from the provision; however, this exemption is not available to unions for professionals (e.g., doctors or lawyers).

The provisions would generally be effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Nondiscrimination Rules for 403(b) Tax-Sheltered Annuities

New nondiscrimination rules would be applied to 403(b) annuities, except for church plans, effective January 1, 1989. The definition of an employer would be clarified for purposes of the nondiscrimination rules. Also, the same coverage and nondiscrimination tests that apply to qualified plans would be applied to nonelective contributions. But only universal availability is required with respect to salary reduction contributions. In applying the nondiscrimination test to educational institutions, students who regularly work less than 20 hours per week may be disregarded and the Secretary of the Treasury is to provide simplified comparability rules.

Social Security Integration

TRAC provides that a plan is not to be considered discriminatory merely because the contributions and benefits under the plan favor highly compensated employees if the plan meets the new requirements (i.e., the disparity limits) relating to the integration of contributions or benefits under qualified plans.

The conference agreement notes: "The conferees recognize that some plans that satisfy both the present-law integration rules and the rules adopted in the House and Senate proposals, may not satisfy the additional limits added by the conference agreement."

Under TRAC, a defined contribution plan meets the disparity limits for integrated plans only if the excess contribution percentage under the plan for compensation over the integration level does not exceed the base contribution percentage by more than the lesser of (1) the base contribution percentage; or (2) the greater of 5.7 percentage points or the percentage equal to the Social Security Old Age Insurance payroll tax rate.

In the case of an integrated excess defined benefit pension plan, TRAC places limits on the extent that the benefit percentage for compensation above the integration level can exceed the benefit percentage for compensation up to the integration level. This limit, called the "maximum excess allowance," with respect to benefits attributable to any plan year of service is the lesser of (1) the base benefit percentage (benefits provided on compensation up to the integration level); or (2) 3/4 of a percentage point. The "maximum excess allowance" for a plan with respect to total benefits is the lesser of (1) the base benefit percentage; or (2) 3/4 of a percentage point times the participant's years of service (not in excess of 35) taken into account under the plan. The 3/4 of a percentage point is reduced as the integration level increases above "covered compensation."

TRAC also requires that any optional form of benefit, preretirement benefit, actuarial factor, or other benefit or feature provided by the plan with respect to remuneration in excess of the integration level specified by the plan for the year be provided with respect to remuneration below the integration level.

A defined benefit pension plan meets the requirements for integrated offset plans if it provides that a participant's accrued benefit derived from employer contributions (sec. 411(c)(1))
may not be reduced by reason of the offset by the lesser of (1) 50 percent of the benefit that would have accrued without regard to the reduction; or (2) 3/4 of a percent of the participant's final average compensation times the participant's years of service with the employer (not in excess of 35) taken into account under the plan. Also, the 3/4 is reduced as final average compensation increases above "covered" compensation. TRAC further limits the size of the offset to an amount comparable to that permitted under present law and contains rules as to the rate at which the offset may accrue under a plan.

The provisions are effective for plan years beginning after December 31, 1988. A special effective date applies to plans maintained pursuant to a collective bargaining agreement.

Uniform Definition of Highly Compensated Employees

TRAC provides a new uniform definition of the group of employees in whose favor discrimination is prohibited ("highly compensated employees") that generally applies for purposes of the nondiscrimination rules for qualified plans and statutory employee benefit plans.

An employee is treated as highly compensated with respect to a year if, at any time during the year or the preceding year, the employee (1) was a 5 percent owner of the employer; (2) earned more than $75,000 in annual compensation from the employer; (3) earned more than $50,000 in annual compensation from the employer and was a member of the top-paid group of employees, the top 20 percent of employees by pay during the same year; or (4) was an officer of the employer and received compensation greater than 150 percent of the dollar limit on annual additions to a defined contribution plan. A special rule applies to new hires and to those with increases in compensation in the current year, i.e., treatment of an employee as a highly compensated employee under any of the last three categories named above is subject to this top-100 employee rule. If for any year no officer of the employer received compensation in excess of this level, the highest paid officer of the employer is treated as a highly compensated employee. The $50,000 and $75,000 thresholds are indexed in the same manner as the indexation of the dollar limit for defined benefit plans under section 415.

Determining Top-Heavy Status

Under TRAC, a uniform accrual rule is used in testing whether a qualified plan is top heavy (or super top heavy), effective for plan years beginning after December 31, 1986. In determining whether a plan is top heavy, the fractional accrual rule is applied. However, at the employer's election, the top-heavy determination may be based on any other accrual method if that method is used for benefit accrual purposes by all plans of the employer.

Benefit Forfeitures

TRAC creates uniform rules for forfeitures under any defined contribution plan, effective for plan years beginning after December 31, 1985.

Vesting

TRAC requires faster vesting schedules for private-sector, single-employer plans. A plan can choose to meet one of two tests: (1) 100 percent vesting after five years of service; or (2) 20 percent after three years of service, with an additional 20 percent for each subsequent year of service until 100 percent vesting is achieved at the end of seven years of service.

Class year vesting that does not meet either of the two new minimum standards will not be permitted, effectively repealing the special class year vesting rule. A special rule is provided in the case of a multiemployer plan to require 100 percent vesting after 10 years of service.

TRAC also provides that the current maximum waiting period for plan participation of three years for plans with full and immediate vesting will be reduced to two years of service. If a plan requires an employee to complete more than one year of service as a condition of participation, the employee must be 100 percent vested when the benefit is accrued.

The provisions are generally applicable for plan years beginning after December 31, 1988, with respect to participants who perform at least one hour of service after the effective date. A special effective date applies to plans maintained pursuant to a collective bargaining agreement. Under a collective bargaining agreement ratified before March 1, 1986, the amendments are not effective for plan years beginning before the earlier of (1) the later of (a) January 1, 1989, or (b) the date on which the last of the collective bargaining agreements terminates; or (2) January 1, 1991. Extensions or renegotiations of the collective bargaining agreement if ratified after February 28, 1986, are disregarded.
Miscellaneous Pension and Deferred Compensation Provisions

Requirement That Collective Bargaining Agreements Be Bona Fide

TRAC clarifies that no agreement will be treated as a collective bargaining agreement unless it is a bona fide agreement between bona fide employee representatives and one or more employers. The provision is effective upon enactment.

Penalty for Overstatement of Pension Liabilities

TRAC provides a new penalty in the form of a graduated addition to tax applicable to certain income tax overstatements of deductions for pension liabilities. As an addition to tax, this penalty will be assessed, collected, and paid in the same manner as a tax. This addition to tax applies only to the extent of any income tax underpayment that is attributable to such an overstatement. The penalty is similar to the present-law penalty for overvaluations of liabilities. The provision is generally effective after December 31, 1986.

Treatment of Certain Fishing Boat Crews as Self-Employed Individuals

Under TRAC, members of fishing boat crews (described in sec. 312(b)(20)) are treated as self-employed individuals for purposes of the rules relating to qualified pension, profit sharing, or stock bonus plans. The provision is effective for taxable years beginning after December 31, 1986.

Cash Out of Certain Accrued Benefits

TRAC amends the rules of the Internal Revenue Code and ERISA relating to cash outs of accrued benefits to require that, for purposes of determining the present value of a participant's accrued benefit, a plan is to use an interest rate (as of the date of distribution) no greater than the interest rate (deferred or immediate, whichever is appropriate) that would be used by the Pension Benefit Guaranty Corporation (PBGC) upon the plan's termination. If the present value using this rate is greater than $25,000, the total benefit may be recalculated by using an interest rate no greater than 120 percent of the PBGC interest rate. In no case, however, may the present value (using the higher rate) be less than $25,000. In addition, TRAC clarifies that certain plan amendments adopting the provision will not constitute a cutback of a participant's accrued benefit.

The provision is applicable for distributions in plan years beginning after December 31, 1984. However, it does not apply to distributions that were made in plan years beginning after December 31, 1984, and before January 1, 1987, if such distributions were made in accordance with the requirements of regulations issued under the Retirement Equity Act of 1984.

Time Required for Plan Amendments, Issuance of Regulations, and Development of Section 401(k) Master and Prototype Plans—Under TRAC a delayed effective date is provided for plan amendments to comply with the provisions of the conference agreement relating to qualified plans.

Furthermore, TRAC provides that the Treasury Department is to issue final regulations by February 1, 1988, for (1) the rules relating to the integration of benefits under qualified plans; (2) the coverage requirements applicable to qualified plans; (3) the amendments applicable to qualified cash or deferred arrangements; and (4) the new nondiscrimination rules for employer matching and employee contributions (sec. 401(m)).

The Internal Revenue Service has not been issuing determination letters for 401(k) master and prototype plans, because final regulations have not been issued. TRAC provides that the Internal Revenue Service begin accepting requests for determination letters with respect to 401(k) master and prototype plans by May 1, 1987.

Employee Leasing

Leased employees would be exempt from the recipient company's pension plan through the safe harbor provision of the Internal Revenue Code (section 414 (n)(5)) if the leasing firm has a money purchase pension plan with a nonintegrated employer contribution of 10 percent (up from 7 1/2 percent in current law). The leasing organization must cover 100 percent of its employees (excluding employees who have compensation of less than $1,000 for the year), and the safe harbor may not be used if more than 20 percent of the individuals performing substantial services for the recipient organization are leased employees. An exemption from the employee leasing recordkeeping requirements would be provided for recipient organizations that have no top-heavy plans and with respect to which only a de minimis percentage of individuals performing substantial services are not employees.
**Implications for Defined Benefit and Defined Contribution Plans**

The changes in TRAC are so complex that determining the implications is only speculation, but EBRI has talked with dozens of plan sponsors in an effort to obtain a preliminary assessment.

1. There is a general belief that the intent of TRAC is to "rebalance" the scale between defined benefit and defined contribution plans. Sponsors believe that on the surface this has been accomplished. They feel that the changes that remove the "executives' stake in the plan," however, leave the ultimate outcome in question.

2. There is a view that traditional thrift/savings plans will have difficulty meeting nondiscrimination tests once employees are aware of the new withdrawal restrictions and the tax status of withdrawals made. This problem will be particularly significant for plans that have made automatic distributions at preset intervals. Many plans with strong 6 percent matches and liberal access have only achieved 70 to 80 percent participation. These sponsors are not optimistic about the future of their plans.

3. 401(k) plans are likely to be maintained and tested. Most sponsors have not experienced high volumes of hardship withdrawals in the past, and are therefore uncertain about the ultimate effect of the withdrawal changes. With matches, as demonstrated above, these plans can still be very attractive. For employers that have communicated these plans as retirement plans, the transition may be smooth. For those that primarily stressed tax-leveraged savings for worklife consumption, the problem may be greater. Finally, given the high cost of implementation of these programs, most believe that waiting a few years to see if tax rates go back up may be the most prudent course.

4. Sponsors clearly see the message in TRAC that qualified plans are intended to be used for retirement savings, and that further legislation in that direction is likely. Portability legislation is already being discussed, and an earlier version of the Senate tax reform bill included a provision requiring a rollover option. Sponsors foresee revision of plans that fall within the section 415 limits to meet this retirement income objective, with stock purchase arrangements and ESOPs taking on new importance for companies that still wish to provide a shorter-term savings vehicle.

5. As part of this support for retirement savings, employers may tighten traditional profit sharing plans to require significant deferral and continue some form of defined benefit program. Plan sponsors discussed a number of possible new directions for defined benefit plans, including a move back to contributory defined benefit plans as a means of achieving more cost sharing of retirement income provision. Others foresee a movement to target benefit plans or floor plans as the way to blend a benefit promise with direct employee involvement in contributions.

6. A consistent theme coming through in EBRI discussions is the potential for enhanced flexibility for design as more and more executives get pushed into nonqualified plans. Sponsors see this reduction in the "executives' stake" as allowing more creative design and cost sharing in all plans and less executive resistance to changes in the traditional defined benefit plan.

7. Overall, there does not appear to be a clear winner in the competition between defined benefit and defined contribution plans as a result of TRAC. In fact, by significantly reducing early retirement benefits for defined benefit plans and establishing a maximum allowable payment from all tax-favored, defined benefit and defined contribution plans that can be received without an excise tax payment, TRAC may lead to entirely new concepts for retirement income provision.

**Statutory Employee Benefit Exclusions**

**Health Insurance Costs of Self-Employed Individuals**

Effective for taxable years beginning after December 31, 1986, TRAC permits self-employed individuals to deduct from gross income 25 percent of the cost of providing health insurance for themselves and their spouses and dependents. This exclusion is allowed only if the insurance plan meets the applicable nondiscrimination requirements (see "Nondiscrimination Rules" below).

**Prepaid Legal Services**

TRAC retroactively extends the exclusion for prepaid legal services for two years through 1987. A transition rule was adopted with respect to group legal services benefits provided under a cafeteria plan. Under the transition rule, the enactment of the law is treated in the same manner as a change in family status under proposed Treasury regulations relating to cafeteria plans. Thus, an employee would be permitted to revoke an election to take cash or a taxable benefit after the period of coverage has commenced and to make an election of group legal coverage with respect to the remainder of the period of coverage. This transition rule applies to an election made to revoke a prior benefit election.
if the new election is made with respect to group legal services benefits in 1986.

Employer-Provided Transportation

The exclusion for employer-provided transportation (van pooling) was not retroactively extended and is treated as having expired on December 31, 1985.

Educational Assistance

TRAC retroactively extends the exclusion for educational assistance for two years through 1987 and puts an unindexed cap on the annual exclusion equal to 1/8 of the Social Security taxable wage base (1/8 x $42,000 = $5,250 for 1986).

Dependent Care Assistance

The maximum exclusion for dependent care assistance will be capped at $5,000 a year ($2,500 for a married individual filing separately) beginning in years after December 31, 1986. Benefit consultants have pointed out that the dependent-care tax credit will rise in value.

Faculty Housing

TRAC provides (effective for taxable years or periods beginning after December 31, 1985) generally that, for federal tax purposes, the fair market value of the use (on an annualized basis) of qualified campus lodging furnished by—or on behalf of—a school, college, or university is to be treated as no greater than 5 percent of the appraised value for the lodging, but only if under Treasury regulations an independent appraisal of the fair market value is obtained by a qualified appraiser.

Accrued Vacation Pay

Under TRAC, the special rule allowing a deduction for additions to a reserve account for vacation pay (sec. 463) is limited to the vacation pay that is paid during the current taxable year or within 8-1/2 months after the close of the taxable year of the employer with respect to which the vacation pay was earned by the employees, effective for taxable years beginning after December 31, 1986.

Nondiscrimination Rules

TRAC establishes comprehensive nondiscrimination rules for certain statutory employee benefit plans. A highly compensated employee who is a participant in any discriminatory statutory employee benefit plan is taxed generally only on the value of the discriminatory portion of the employer-provided benefit under the plan if such portion is timely reported.

The conference agreement (1) revises the nondiscrimination rules applicable to group-life term insurance plans and self-insured accident or health plans; (2) extends those rules to insured accident or health plans; (3) establishes a new nondiscrimination test applicable to dependent care assistance plans; (4) makes the uniform definition of highly compensated employee, employer, and compensation generally applicable under the nondiscrimination rules for qualified plans; (5) permits satisfaction of the nondiscrimination tests on a controlled group, line of business, or operating unit basis; and (6) contains a special transition rule for certain dispositions or acquisitions of a business. Present-law concentration tests would continue to apply. Educational assistance and group legal services are not subject to the new nondiscrimination rules because the exclusions for those benefits are scheduled to expire before the effective date of the new nondiscrimination rules.

Under the new nondiscrimination rules, accident, health and group-term life insurance plans must meet an eligibility test and a benefits test or an alternative to the eligibility and benefits tests. For accident and health plans, it is the value of the coverage provided, not the contributions, that is subject to the nondiscrimination rules.

The eligibility test requires that the employer satisfy three requirements. The first is that nonhighly compensated employees must constitute at least 50 percent of the group of employees eligible to participate in the plan. This requirement can be satisfied if the percentage of highly compensated employees who are eligible to participate is not greater than the percentage of nonhighly compensated employees who are eligible. This allowance is important to smaller firms where more than 50 percent of the workers are defined as highly compensated. In such cases, 100 percent of the nonhighly compensated would have to be eligible in order for the test to be passed. The second requirement is that at least 90 percent of the employer's nonhighly compensated employees are eligible for a benefit that is at least 50 percent as valuable as the benefit made available to the highly compensated employee with the most valuable benefits.
Finally, the third requirement provides that a plan may not contain any provision relating to eligibility to participate that suggests discrimination in favor of highly compensated employees.

The benefits test requires that the average employer-provided benefit received by nonhighly compensated employees under all plans of the employer of the same type is at least 75 percent of the average benefit received by highly compensated employees under all plans of the employer of the same type. Average employer-provided benefit is defined as the aggregate employer-provided benefits received by the highly or nonhighly compensated group divided by the number of employees in the respective group, whether or not they were covered by any of the plans.

As an alternative to the eligibility and benefits test, an employer can meet the nondiscrimination rules if a plan benefits at least 80 percent of an employer's nonhighly compensated employees. Only individuals who receive coverage under a plan will be considered benefiting from the plan; eligibility to receive coverage is not sufficient.

Cafeteria plans retain the present-law eligibility test, but do not have the current-law special cafeteria plan benefits tests. This means that each type of benefit available under a cafeteria plan is subject to its own applicable nondiscrimination rules and to any applicable concentration test.

Full-time life insurance salesmen can participate in cafeteria plans, and employees of educational organizations may elect postretirement life insurance coverage under a cafeteria plan. TRAC also provides that salary reduction under cafeteria plans is excluded from the FICA and FUTA wage bases. The explicit exclusion from FICA and FUTA taxes for section 125 plans responds to concern that the Internal Revenue Service and some members of Congress want to extend these taxes to the plans by interpretation. The explicit wording in TRAC means that such an extension can only be achieved through legislation. Furthermore, it leaves no question about congressional intent.

The nondiscrimination rules are generally effective for the later of (1) plan years beginning after December 31, 1987; or (2) the earlier of plan years beginning at least three months following the issuance of Treasury regulations or after December 31, 1988.

Under TRAC, ESOPs are one of the few areas to actually get more favorable tax treatment than current law. TRAC preserves all of the 1984 incentives and adds additional ESOP financing incentives, including a deduction for dividends used to repay ESOP loans, a 50 percent estate tax exclusion on the proceeds from the sale of employer stock from an estate to an ESOP, and a number of technical corrections clarifying ESOP provisions.

TRAC does repeal the special payroll-based ESOP tax credit for compensation paid or accrued after December 31, 1986, but a special transition rule is provided. ESOPs will be subjected to the $200,000 salary basis for contributions.

Additional Tax Benefits for ESOPs

TRAC permits an exclusion from the gross estate of 50 percent of the proceeds from a sale of employer securities to an ESOP or eligible worker-owned cooperative. The provision is effective for sales after the date of enactment and before January 1, 1992.

The deduction for dividends paid on ESOP stock is expanded to apply to dividends to repay ESOP loans used to acquire the stock on which the dividends are paid. The provision is effective for taxable years beginning after the date of enactment.

TRAC extends the 50 percent exclusion for interest paid on securities acquisition loans (sec. 133) to refinancing of loans used to acquire employer securities after May 23, 1984. In addition, the exclusion is modified in two respects. First, TRAC provides that the exclusion is also available with respect to a loan to a corporation to the extent that, within 30 days, employer securities are transferred to the plan in an amount equal to the proceeds of the loan and such contributions are allocable to participants' accounts within one year after the date of the loan. Second, a lender eligible for the interest exclusion is amended to include a regulated investment company (as defined in sec. 851). These modifications are effective for loans used to acquire employer securities after the date of enactment.

Changes in Qualification Requirements for ESOPs

Under TRAC, additional requirements are provided for any ESOP. These additional qualification requirements (1) permit
distributions upon termination of an ESOP; (2) modify the distribution and put-option requirements; (3) modify the special limits on allocations of contributions to an ESOP to conform the definition of highly compensated employee to the new definition provided for qualified plans generally; (4) require stock bonus plans to satisfy the put-option requirements applicable to ESOPs; (5) permit an eligible plan participant to direct the ESOP trustee to diversify a portion of the participant's account balance; (6) require the value of employer securities to be determined by an independent appraiser; and (7) eliminate, with respect to ESOPs maintained by certain closely held newspaper publishers, the pass-through voting requirements.

The provision permitting distributions upon plan termination generally is effective for termination distributions made after December 31, 1984. The distribution requirements and the extension of the put-option requirement to stock bonus plans are effective for distributions attributable to stock acquired after December 31, 1986.

The final ESOP provisions of TRAC represent a decision to continue treating ESOPs as ERISA plans, thus subjecting them to the 10 percent tax on early withdrawals (after January 1, 1990) and encouraging stream of payment distributions. The use of ESOPs as a technique of corporate finance is very much reinforced by TRAC, however, and ESOP advocates believe that the overall effect of the provisions will be to increase the use of ESOP financing.

♦ Technical Corrections

Tax Reform Act of 1984

TRAC includes technical corrections to the Tax Reform Act of 1984, which affect, among other things, changes in the welfare benefit, pension plan, "fringe benefit," and employee stock ownership provisions.

Retirement Equity Act

TRAC also includes technical corrections to the Retirement Equity Act of 1984.

COBRA

Technical corrections to the Consolidated Omnibus Budget Reconciliation Act of 1985 are also included in TRAC, effective as if included in COBRA. The amendments include the following:

(1) Divorced or legally separated spouses of employees, and dependents who reach the plan's limiting age have 60 days to notify the plan administrator of these qualifying events.

(2) Qualified beneficiaries covered under a plan ("continuues") can have multiple qualifying events (and, thus, multiple continuation elections), but in no event must coverage be continued beyond 36 months from the date of the first qualifying event.

(3) All qualified beneficiaries are entitled to separate elections for continuation coverage. Thus, the spouse or dependents of a terminated employee may elect continuation coverage (if they were covered before the qualifying event), even if the employee chooses not to continue his or her coverage, or elects different coverage.

(4) Premiums from continuues would be considered timely if received within 30 days of the due date, or within a grace period allowed to the employer or plan by its insurer, if longer than 30 days.

(5) Health plan coverage must be modified for "continuues" whenever coverage is modified for similarly situated beneficiaries (e.g., covered employees and dependents) for whom no qualifying event has taken place. This change also clarifies that all health plan options available to covered workers and dependents must also be available to continuues.

TRAC also clarifies that health insurance coverage need not be continued if a qualified beneficiary becomes covered under another group health plan, "as an employee or otherwise." The conference agreement also clarifies that the conferees do not intend that an employer could compel a qualified beneficiary to pay for noncore benefits (such as vision and dental care) even if active employees are required to purchase coverage for such benefits under the plan.

♦ Revenue Projections under Tax Reform

Congress projects an additional $44.4 billion in tax revenues over five years due to employee benefit tax changes (see table 1). For fiscal year (FY) 1987, employee benefit provisions are estimated to save $4.4 billion. This figure jumps sharply in FY 1988 to $9.3 billion and rises steadily each year thereafter: $9.4 billion in FY 1989; $10.2 billion in FY 1990; and $11.1 billion in FY 1991.
Most of the tax savings are generated by the changes in the tax deductibility of individual retirement accounts ($23.8 billion from FY 1987-FY 1991). Tax deductible IRAs were limited in part because Congress determined that employer-sponsored retirement plans do a better job of ensuring adequate retirement income for workers at all earning levels.

**Conclusion**

Congress had not even completed work on the tax bill when the calls hit the press for more "tax changes." The advocates of new action come from many different directions, for many different reasons.

Employee benefits represents an example of the reason many will advocate change: groups that lost something in the reform process of the last two years will want to regain some ground. Employee benefit interests will want expansion of IRA deductions, creation of a new individual medical account, higher limits and less stringent ADP tests for cash or deferred arrangements, elimination of the $200,000 ceiling on "includible" compensation, and more generous benefits for early retirement. And the list goes on.

The success of those who want reversals of TRAC provisions will depend on evidence supporting their cases, but it will take years to develop the evidence. For example, if large numbers of small employers terminate their plans, it would be evidence that the tightened restrictions in TRAC go too far. Or, if large firms cut back programs and expand nonqualified arrangements and, on the welfare benefit side, pull the "highly compensated" out of the standard health plan only to continue to provide them with a rich plan, it would be seen as evidence that the tighter rules did not always achieve the objectives of lawmakers.

Rep. Rostenkowski, who in August 1986 called for a near-term review of the new lower rates to raise revenue to help bring down the deficit, represents the "revenue raisers." The "revenue raisers" will probably soon be planning a strategy for action for the next Congress as the federal deficit continues to remain high.

At the other extreme from the "revenue raisers" are the "free marketers" looking for a more neutral and less progressive tax code than that represented by TRAC. This group believes that they have been vindicated by TRAC and view it as only a first step in the reform process.

Also certain they want change are the advocates of a value-added tax (VAT) or consumption tax. This group offered VAT as an option when the broader tax reform legislation in the House slowed in the fall of 1985. Again it was advocated in the spring of 1986, when the prospects of tax reform seemed to be in trouble in the Senate Finance Committee. Now, they can argue that a VAT provides the way to raise revenue to help solve the deficit and reduce the corporate tax rate below the TRAC level while preserving tax rates for individuals.

Then, there are the lawmakers and citizens who say that "enough is enough" and that we need time to adjust to the new reformed system. One might expect most candidates for the presidency in 1988 to join this group.

In conclusion, the years ahead will be interesting and challenging for those involved with employee benefits. At the same time massive redesign and amendments will be required to comply with TRAC, Congress is considering mandating additional benefits and continuing the ongoing debate over tax policy and employee benefits.
Appendix

Effective Dates of Selected Provisions Affecting Executive Compensation, Qualified Plans, and Welfare Benefit Plans of the Tax Reform Act of 1986*

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* The page numbers after each provision refer to the section of the conference agreement where the provision is discussed.
10 percent excise tax on surplus reversions (pp. II-482 to II-484)

Reversions attributable to plan terminations on or after 1/1/86; ESOP exception expires after 12/31/88.

401(k) - $7,000 cap on 401(k) deferrals; distributions upon sale of subsidiary, treatment of excess contributions, aggregation of certain nonelective contributions in ADP test. (pp. II-380 to II-391)

Plan years beginning after 12/31/86 (later for collectively bargained plans).

Phaseout of IRA deduction for qualified plan participants (pp. II-373 to II-380)

Taxable years beginning after 12/31/86, except that the provision eliminating the requirement that the spouse have no earned income to be eligible for the spousal IRA contribution is effective for years beginning after 12/31/85.

Elimination of 10-year averaging (pp. II-458 to II-462) Phaseout of capital gains treatment (pp. II-458 to II-462)

1/1/87, except participant age 50 by 1/1/86 may elect one-time use of 5-year averaging (or 10-year averaging at present law rates) before age 59 1/2 and to retain pre-1974 capital gains treatment at 20 percent rate.

Basis recovery rules (pp. II-458 to II-462)

Amounts received after 12/31/86, except distributions of pre-1987 employee contributions if plan on 5/5/86 made these contributions available for distribution under a plan before separation from service.

→ Preannuity starting date distributions (pp. II-461 to II-462)

Annuity starting dates after 7/1/86.

Repeal of 3-year basis recovery rule (pp. II-462 to II-463)

Years beginning after 12/31/86 (later for collectively bargained plans).

Section 415 limits (pp. II-466 to II-482)

Loans made, renegotiated, extended, renewed, or revised on or after 12/31/85.

Loans (pp. II-463 to II-465)
Nondiscrimination coverage (pp. II-410 to 417) and participation rules (pp. II-420 to II-424)

Integration (pp. II-427 to II-440)

Vesting (pp. II-424 to II-427)

Definition of highly compensated (pp. II-442 to II-448)

Nondiscrimination testing of employee after-tax contributions (pp. II-392 to II-397)

Limit on includible compensation (p. II-478)

Plan years beginning after 12/31/88 (later for collectively bargained plans).

Plan years beginning after 12/31/88 (later for collectively bargained plans).

Plan years beginning after 12/31/88 (later for collectively bargained plans).

Years beginning after 12/31/86, except to the extent that the substantive rule to which it relates is effective at a later time.

Plan years after 12/31/86 (later for collectively bargained plans and for tax-sheltered annuities).

With respect to a defined benefit pension plan, the $200,000 limit applies to each year's compensation (including years before 1989), not solely to the final average or career average compensation of an individual.

Years beginning after 12/31/86.

Years beginning after 12/31/88 (later for collectively bargained plans). "Qualified offset" plans in existence on 4/16/86 are exempt from this rule.

Taxable years beginning after 12/31/86 (later for collectively collectively bargained plans).

Plan years beginning after 12/31/88, except for churches.

Effective Date

Plan years beginning after the later of (1) 12/31/87 or (2) the earlier of plan years beginning at least three months after issuance of IRS regulations or 12/31/88.
Deductibility of health insurance costs of self-employed individuals

Taxable years beginning after 12/31/86.

Extension of exclusion of educational assistance and group legal assistance (pp. II-539 to II-542)

Exclusion scheduled to expire after 12/31/87.

$5,000 cap on dependent care assistance (pp. II-539 to II-542)

Taxable years beginning after 12/31/86.

Accrued vacation pay (pp. II-546 to II-548)

Taxable years beginning after 12/31/86.

ESOPs (pp. II-550 to II-560)

Effective Date

ESOP financing incentives (pp. II-550 to II-560)

Taxable years beginning after date of enactment.

Estate tax exclusion (pp. II-556 to II-560)

Sales after date of enactment by estate required to file a return after that date and before 1/1/92.

Exclusion of interest on loans to ESOP (pp. II-556 to II-559)

Loans used to acquire employer to securities after 5/23/84.

Distribution upon plan termination (pp. II-553 to II-558)

Termination distributions after 12/31/84.

Repeal of PAYSOP credit (p. II-558)

For compensation paid or accrued after 12/31/86.

Put option/distribution requirements (pp. II-555 to II-558)

Distributions attributable to stock acquired after 12/31/86.

Definition of highly compensated (pp. II-557, II-442 to II-448)

Plan years beginning after 12/31/86.
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