REPORT #547

TAX SECTION

New York State Bar Association

1986 TAX REFORM ACT SEMINARS

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REPORT #547

NEW YORK STATE BAR ASSOCIATION

TAX SECTION

1986 TAX REFORM ACT SEMINARS

SESSION THREE: EFFECT OF THE 1986 ACT ON QUALIFIED RETIREMENT PLANS

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Individual Retirement Accounts (IRAs)

Section 1101-1103 of the Act

I Overview: Prior to the Economic Recovery Act of 1981 (ERTA), no IRA deductions were permitted if the taxpayer was an active participant in a tax-qualified plan. Also, nondeductible IRA contributions were not permissible. However, it was generally considered that active participation in a plan could be negated either by opting out of coverage or by not making the mandatory contributions necessary to attract an employer contribution or accrual. After ERTA all taxpayers could make deductible contributions to an IRA up to the $2,000 or $2,250 limits whether or not covered by a qualified plan. Under the Tax Reform Act of 1986, taxpayers may make tax deductible or nondeductible contributions to an IRA up to defined limits. Tax deductible limits are based upon amounts of adjusted gross income and marital and tax return filing status if the taxpayer or spouse is covered by a tax-qualified plan.

II Deduction Limits –

A. If the taxpayer and his spouse are not active participants in a tax-qualified plan, then the old $2,000 or $2,250 deductible limits still apply regardless of the amount of adjusted gross income.

1. If a married individual files a separate return, it appears that such individual if not covered by a qualified plan is entitled to a $2,000 deduction even if the spouse is covered by a qualified plan.

B. No IRA deduction is available in the following cases:

1. Married individuals file a joint return, either spouse is an active participant in a qualified plan and adjusted gross income (AGI) exceeds $50,000. – If AGI is between

$40,000 and $50,000, the deductible amount of $2,000 (or $2,250 in the case of one spouse with no income) is reduced in the ratio that AGI in excess of $40,000 bears to $10,000. In other words, if AGI is $48,000, the reduction factor is 8O%, i.e. $8,000 divided by $10,000, and the maximum deduction is $400 (or $450 in the case of one spouse with no income).

2. Single individual files a separate return, is an active participant in a qualified plan and AGI exceeds $35,000. - If AGI is between $25,000 and $35,000, the deductible amount of $2,000 is reduced in the ratio that AGI in excess of $25,000 bears to $10,000.

3. Married individual files separately, is an active participant in a qualified plan and AGI exceeds $10,000. - If AGI is less than $10,000, the deductible amount is reduced in the ratio that AGI in excess of zero Sears to $10,000.

C. Special Rules of Importance –

1. AGI is calculated without regard for IRA deductions, with regard for taxable social security benefits and with regard for passive loss limits.

2. According to the Conference Committee Report, an active participant in a pension plan includes any person who is eligible for coverage even if the person elects not to participate, i.e., opts out or refuses to make mandatory contributions. Also, participation in a section 401(k) plan with no employer contribution is active participation in a qualified plan.

III Nondeductible contributions -

A. Limitation - Amounts allowable as deductions under the general IRA rules determined without the new limitations minus the amounts allowable under the limitation,

except that contributions may be designated as nondeductible contributions on taxpayer's return.

B. All nondeductible contributions must be designated nondeductible contributions on the taxpayer's return and the taxpayer must also report any amount received from an IRA. In either case the following information must also be shown on the taxpayer's return:

1. Amount of designated nondeductible contributions for the year;

2. Amount of IRA distributions for the year;

3. Excess of total designated nondeductible contributions for all years over aggregate distributions from IRAs which were excludable for all years;

4. Aggregate balance of all IRAs; and

5. Whatever else the Secretary requires. (Note: overstatement of designated nondeductible contributions is subject to a $100 penalty for each overstatement.)

IV Taxability of Distributions

A. All IRAs treated as one IRA, including rollover IRAs and SEPs.

B. All distributions treated as distributed from one IRA.

C. Amount excludable from income is determined in the ratio that total nondeductible contributions bears to total value of all IRAs at year end plus amounts withdrawn. For example, assume the taxpayer has an old rollover IRA worth $100,000 and a new non-rollover IRA worth $4,000 to which he has made nondeductible contributions of $2,000. If he withdraws the entire non-rollover IRA of $4,000, the non-taxable amount is $2,000 divided by $104,000 times $4,000 or $76.92!

V Withholding

A. All amounts distributed from an IRA are treated as includable in income for withholding tax purposes.

VI Investments in Collectibles

A. Rules treating IRA investments in collectibles as distributions do not apply to investments in gold and silver coins of the U.S. - Section 1144.

VII Observations and Questions

A. Since deductible IRAs will be available after 1986 only to married taxpayers with AGI of $50,000 or less, unmarried taxpayers with AGI of $35,000 or less and married taxpayers filing separately with AGI of $10,000 or less, why are the new rules so complicated?

B. What is the policy justifying the denial of IRAs to those who in fact have no qualified plan benefits by reason of having opted not to participate in such?

C. Why should old IRAs be lumped with new IRAs in connection with return of nondeductible contributions?

D. Why should a separated married employee filing separately be treated so harshly under the $10,000 rule?

<u>Plan Loans - Section 1134 of the Act</u>

I Loan Limit Reduction

A. $50,000 under present law is reduced to $50,000 minus highest outstanding balance on any other loan during one year period preceding new loan.

II Repayment

A. Substantially level amortization required with payments not less frequently than quarterly.

B. Residential loan exception to 5 year repayment rule - changed from acquisition, construction, reconstruction or rehabilitation of principal residence of participant or member of participant’s family to acquisition of principal residence of participant.

III Interest Deduction

A. No deduction or addition to basis for interest on loans from any plan to a key employee.

B. No deduction or addition to basis for interest on loans secured by elective section 401(k) or 403(b) deferrals.

IV Effective Date - Loans made, renewed, renegotiated, modified or extended after December 31, 1986.

V Coordination with New Limitations on Interest Deductions

A. Post-1986 loans to non-key employees not secured by section 401(k) or 403(b) deferrals - interest is deductible to extent permitted under new limitations applicable to consumer interest, investment interest or residential interest.

B. Pre-1987 loans - interest is deductible to extent Permitted under new limitations.

VI Coordination of Residential Loan Rules for Purposes of Preserving Interest Deduction after 1986.

A. Pre-1987 loans -

1. Plan rules - loan must be used in acquisition, construction, reconstruction, or rehabilitation of principal residence of participant or family member - otherwise subject to 5 year repayment rule.

2. Regular tax rules - loan must be secured by a perfected lien on principal residence or second residence of borrower and amount of loan may not exceed borrower's cost basis (or value if less) plus cost basis of improvements minus other debt.

3. Alternative tax rules - loan must be incurred in acquiring, constructing or substantially rehabilitating a principal residence or qualified dwelling or in refinancing any such loan.

4. Combination of above rules

a) Plan loans in excess of 5 years - loans must be used in acquisition, construction or rehabilitation of principal residence of participant and plan must have a perfected lien on such residence.

b) Plan loans of 5 years or less – loan must be secured by perfected interest on first or second residence and must be incurred in acquiring, constructing or rehabilitating first or second residence or refinancing same.

B. Post - 1986 loans

1. No deduction or basis allowed for interest on loans to key employees or secured by section 401(k) or 403(b) deferrals.

2. Plan loan in excess of 5years – Must be to acquire principal residence of participant and secured by a perfected lien on such residence.

3. Plan loan of 5 years or less – same as 4(b) above.

4. Query whether loan out of 401(k) account secured solely by principal residence and/or non-40l(k)money in plan account avoids the new no-deduction rule.

Class Year Thrift Plans

I Class year thrift plans qualify as profit-sharing plans. They require an employee to make voluntary contributions as a requisite for participation and in many cases such contributions may be made as before-tax salary deferral under section 401(k). Employer contributions are determined and allocated based upon employee contributions and are called matching employer contributions, generally from 50% to 100% of the employee contributions. Under longstanding IRS rules, employee mandatory contributions of up to 6% of compensation have been generally permissible without concern for the anti-discrimination rules. Class year plans are subject to special vesting requirements under ERISA and the Code in that employer contributions for each year vest separately and must vest fully not later than the end of the 5th year following the year for which the contributions were made. Many thrift plans permit participants to elect distribution of their class year accounts in the year after vesting. Under current IRS interpretations, participants are treated as having received a return of their own money without tax in such distributions so long as they have unrecovered basis in the plan.

II Nondiscrimination Requirements for Employer Matching Contributions and Employee Contributions - Section 1117 of the Act –

A. Contribution percentage for eligible highly compensated employees may not exceed the greater of: (i) 125% of such percentage for all other eligible employees, or (ii) the lesser of 200% of such percentage for all other eligible employees, or such percentage for all other eligible employees plus 2 percentage points.

1. Contribution percentage means average of the ratios (calculated separately for each employee) of sum of matching contributions and employee contributions to employee's compensation. Compensation means compensation currently includable in gross income, but may include at the employer's election compensation deferred under

sections 125, 401(k), 402(h) or 403(b). Employer may elect to include elective deferrals and qualified nonselective employer contributions.

2. Matching contribution means an employer contribution made on account of an employee contribution or an employee's elective deferral.

3. Elective deferrals are section 401(k) contributions.

4. Nonelective employer contributions are employer contributions which satisfy CODA requirements as to vesting and withdrawal, and may not be withdrawn on account of hardship.

5. Excess contributions and earnings thereon must be distributed by close of following plan year to preserve plan qualification or within first 2-1/2 months of following plan year to avoid 10% excise tax.

6. Effective for years beginning after December 31, 1986.

B. If a thrift plan has a section 401(k) feature, as most do, then it must satisfy these rules in the following order:

a) Section 402(g) - $7,000 limit on elective deferrals;

i) Excess over $7,000 is taxable.

b) Section 401(k) - 125% or 200% - 2 percentage tests must be met separately as to elective deferrals and qualified employer contributions;

C) Section 401(m) - the new employer matching and employee contribution rules where employee contributions and nonqualified employer contributions are added to the calculation; and

d) Section 415 limits.

III Vesting - Section 1113 of the Act

A. Class year vesting is repealed.

B. Effective for plan years beginning after December 31, 1988.

IV Taxation of In-Service Distributions - Section 1122(c)

A. Old basis recovery rules no longer applicable to in-service distributions or withdrawals except as to pre-1987 employee contributions if plan permitted in-service withdrawals on May 5, 1986.

B. After pre-1967 basis is recovered, post-1986 employee contributions are treated as a separate account so that each withdrawal or distribution of employee money is treated as proportionately employee money (non-taxable) and earnings thereon (taxable).

C. Taxable portion is subject to 10% excise tax on early distribution if made prior to attainment of age 59-1/2.

A. New Rules for Deductibility of Qualified Plan Contributions (404)

1131(a) — 1. Defined contribution plans

404 (a)(3)(A) 12/31/86 — (a) Repeal of shortfall ("limitation") carryforward, with pre-'87 carryforwards grandfathered.

(b) Excess contribution carryforward remains, subject to 15% limitation in year to which carried.

(i) But excess subject to 10% excise tax.

4972 1131(c) — 2. Defined benefit plans

(a) Limit, with carryforwards, remains the same.

4972 — (b) But 10% excise tax imposed excess that is not currently deductible.

1138 6659A — (c) If underpayment of tax is attributable to overstatement of pension liabilities (leading to a non-deductible excess contribution), 10%-30% penalty on underpayment.

(i) Applies to taxes for 1986.

(ii) May be waived if taxpayer shows reasonable basis.

II-492 — (iii) May be waived if taxpayer shows reasonable basis.

(iv) De minimis exception if underpayment less than $1,000.

1106(d)(2)
404(1)

(d) All benefit and cost calculations must be based on individual compensation not in excess of $200,000 (subject to C/L adjustment).

1106(i)
(5)(A)

(i) Effective with respect to benefits accruing after 12/31/88.

B. New 401(k) Plan Rules

1. Deduction limits

1105(a)
402(g)

(a) $7,000 limit (subject to cost of living adjustment) on deductions for elective deferrals.

(i) limit increased to $9,500 if elective deferrals used to purchase an annuity contract under 403(b).

402(g)(2)

(b) Non-deductible excess may be reallocated among plans by the following 3/1 and may be refunded by the following 4/15, but these refunded amounts count towards adp for the highly compensated, for purposes of the 401(k)(3) distribution-of-participation requirement (see 2 below).

(i) refunded excess is not included in gross income or subject to additional 10% tax (see 3 under Taxability of Distributions), but income allocable to refunded excess is taxable in year of excess deferral.

1105(c)(5)

(c) $30,000 limit remains in effect for 1986 plan year, but if contributed in 1987 employer must "identify the amount" of its contribution before 1/1/87.

2. Required distribution participation in deferrals

1116(a)

(a) Shrinks 1.5 to 1.25, 3% to 2%, and 2.5 to 2 in permissible discrepancies between adp for the highly compensated and adp for other employees.

1116(d)
401(k)(5)
1114(a)

(b) Highly compensated group no longer the top 1/3, but as defined by new 414(q):

(i) 5% owner

(ii) Compensation over $75,000

(iii) Compensation over $50,000 and in top 20%

(iv) officer with compensation over 150% of dc plan limit

(A) old 50-3-10% rule

(v) new employees only if among 100 highest paid

(vi) aggregate certain family members

(vii) include certain former employees

(viii) taint carries over for one year or more (indefinitely for former employees?)

414(q)(1),(9)

1116(c)(3)
401(k)(8)

(c) If the highly compensated over contribute can avoid disqualification by distributing excess (plus allocable income) to them before close of following plan year.

1116(c) 401(k)(8)(D)	(i) No 10% additional tax under 72(t) imposed on receipt or excess amounts that must be distributed to cure.
1117(b) 4979(f)	(ii) But new 10% excise tax imposed on excess contributions unless distributed within 2-1/2 months after year end.
1116(f)(2),(3)	(d) Effective for years beginning after 12/31/86.
12/31/88	3. Other special qualification rules
401(k) (2)(d)	(a) Not more than one year of service for eligibility.
401(k)(4)	(b) Except for matching contributions, no other employer benefit may be contingent on electing to defer.
401(k) (2)(b)	(c) May not permit distribution prior to separation from service, death, disability, age 59 ½ and in 3 special situations. In-service distributions permitted for hardship (but see 3 under Taxability of Distributions).
1117(a) 401(m)	4. New distribution-of-participation requirements for employer matching contributions and employee after-tax contributions.

401(m) (2)(A)	(a) The 401(k) 1.25-200%-2% test will now apply as well to employer matching contribution and employee after-tax contributions.
401(m)(2) II-395	(b) In testing for distribution of participation, employer may elect to aggregate matching contribution and employee contributions with elective deferrals and qualifying mandatory employer contributions.
1117(d)(1)	(c) Effective for plan years beginning after 12/31/86.

C. New Limits on Individual Contributions and Benefits (415)

1106(a)
415(c)(1)(a)

1. Defined contribution plans

(a) $30,000 limit remains, but no adjustment until DB limit exceeds $120,000.

1106(b)
415(b)(2)
(c),(D)

2. Defined benefit plans

(a) $90,000 limit remains, but now keyed to Social Security retirement age, not 62-65.

415(b)(2)
(F),(G),(9)

(b) $75,000 as floor at 55 and as starting point for below 55 eliminated (except for governmental and tax-exempt employees, police, fire, fighters, airline pilots).

1106(f)
415(b)(5)

(c) Required less-than-10-year reduction in limit keyed to participation, not service.

1106(i)(1)

(d) Effective for years beginning after 12/31/86.

1106(d)(1)
401(a)(17)

3. Benefits and contribution may not be based on compensation in excess of $200,000 (subject to c/l adjustment)

1106(i)(5)

(a) Effective with respect to benefits accuring in years beginning after 12/31/88.

1106(h)	4. May incorporate $415 limitations by reference.
1118	5. Ratable accruals
II-440	(a) Solely for purposes of determining whether a plan is top heavy the accrued benefit of any non-key employee must be determined by using the accrual method used under all the employer's plans.
1118(b)	(b) If the plans use different methods, then must use slowest accrual rate permitted under the "fractional" (411(b)(1)(c)) rule.
	(c) Effective for plan years beginning after 12/31/86.

D. New Rules for Taxability of Distributions

1121(b)
401(a)(9)(c)

1. Distributions must now commence by April 1 in year after reaching 70-1/2 for everyone.

1121(d)

(a) Effective for years beginning after 12/31/88, but see transition rules.

1121(a)
4974

2. 50% excise tax for failure to make minimum distributions (excess accumulations) extended from IRA's to qualified plans.

(a) Waived if due to reasonable error, and steps taken to remedy.

1121(d)

(b) Effective for years beginning after 12/31/88, but see transition rules.

1123(a)
72(t)

3. 10% additional tax on premature distributions (prior to 59-1/2, death or disability) extended from IRA's (Section 408(f)) and key employees (Section 72m(5)) to all qualified plans.

72(t)(2),
3(B)

(a) Exception for installments commencing after separation from service and keyed to life or life expectancy, early retirement after age 55 (not for IRA's), and distributions equal to deductible medical expenses (not for IRA's).

(i) Retroactive imposition (with interest) if permissible installments subsequently improperly modified.

(b) Applies to lump sum distributions on termination of employment (unless rolled over) and to in-service distributions.

(c) Is there an ERISA anti-cutback problem? Is there a contract commitment problem?

1133(a)
4981

4. 15% excise tax on excess distributions.

(a) Applies to aggregate distributions in any one year in excess of ($112,500)
($150,000)
with C/L increases from all qualified retirement plans and all IRA's.

(i) No adjustment for form of benefit.

(ii) QUADRO distribution taxable to alternate payee.

(b) Separate safe harbor for qualifying lump sum distributions of up to ($562,500).
($750,000)

4981(c)(5)

(c) Election filed for 1988 (or 1987) tax year grandfathers accumulations (accrued benefit) up to 8/1/86, but only if greater than $562,500.

(i) Effect of 1988 election on 1987 excess distribution.

4981(b) (d) Excise tax reduced by any attributable additional tax imposed under 72(t).

4981(d) (e) 15% additional estate tax on any "excess accumulation" remaining on death.

(i) No unified credit; no marital deduction; 691(c) deduction?

(ii) Grandfathering election does not appear to apply to estate tax, posing a possible dilemma.

1133(c) (f) Effective with respect to distributions made or decedents dying after 12/31/86.

1112(c)
402(b)(2)
II-416
1/1/89

5. Highly compensated will be taxable on the value of their vested accrued benefit (less employee contributions) in the year a plan is disqualified for discrimination.

(a) Consider application to a highly compensated retired employee.

1139(a), (b),(c)
411(a) (11)(B)
417(e)

6. Cash-out of Accrued Benefits

ERISA
203(e)(2)
II-487

(a) Substitutes a two step approach in determining present value, and seemingly applies it to all cashouts regardless of size (or consent).

(i) If PV of accured benefits does not exceed $25,000 using PBGC LSD termination rate (i.e., present law), then must use this rate in determining PV of accrued benefits.

(ii) If PV of accrued benefits exceeds $25,000 using PBGC rate, then can use 120% of PBGC rate in determining PV, but not to bring PV below $25,000.

1139(d)

(b) Effective Date -- Applies to distributions in plan years beginning after 12/31/84.

(i) exception -- Not applicable with respect to distributions made after 12/31/84 and before 1/1/87 in accordance with regulations under REA.

(ii) Plan amendments adopting this section are granted anti-cutback protection.

Lump Sum Distributions - Section 1122 of the Act

I Present law continues to apply to participants who attained age 50 before January 1, 1986.

A Choices:

1. 20% tax on capital gain pre-1974 portion plus 10 year forward averaging on post- 1973 portion at 1986 tax rates.

2. 10 year forward averaging on entire amount at 1986 tax rates

Or at participant's election

3. 20% tax on capital gain pre-1974 portion plus 5 year forward averaging on post-1973 portion at new tax rates.

4. 5 year forward averaging on entire amount at new tax rates.

II Effective in 1987

A. 5 year forward averaging and capital gain phased out 5% in 1988, 25% in 1989, 50% in 1990, 75% in 1991 and 100% thereafter.

B. It is unclear how election of capital gain after 1987 will be of any benefit where capital gain is subject to same 28% rate.

C. Only one lifetime election permitted and participant must be 59-1/2.

D. Participant may elect not to have tax deferred on unrealized appreciation in employer stock.

Minimum Coverage and Participation
Section 1112 of the Act

I Minimum coverage must meet one of the following requirements:

A. Plan benefits 70% of employees who are not highly compensated.

B. Plan benefits a percentage of employees who are not highly compensated which is at least 706 of the percentage of highly compensated employees covered by the plan, or

C. Reasonable classification found not to be discriminatory and average benefit percentage for low paid is at least 70% of the average benefit percentage for highly compensated employees. Average benefit percentage means the contribution or benefit of an employee under all qualified plans of the employer expressed as a percentage of compensation.

II Additional Participation Requirements -

A. Plan must on each day of the plan year benefit the lessor of 50 employees or 40% or more of all employees of the employer. No aggregation is permitted for this requirement.

B. May exclude employees who do not meet age or service requirement or who are covered by a collective bargaining agreement.

C. Secretary may by regulation provide that any separate benefit structure, separate trust or other separate arrangement is to be treated as a separate plan.

D. Any plan in existence on August 16, 1986 may terminate if it fails the 50 employee - 40% test and the reversion to the employer will not be subject to the 10% employer reversion tax provided there is no transfer of assets,

liabilities, merger or spinoff after August 16, 1986.

Integration with Social Security
Section 1111 of the Act

I Defined Contribution Plans –

A. Under present law a plan is properly integrated if contributions on compensation above the social security wage base ($42,000 in 1986) do not exceed the employer OASDI tax rate for old-age insurance (currently 5.7%) plus the rate of employer contributions on compensation within the wage base. For example, if the employer contributes 5% on the first $42,000 of compensation, it could contribute 10.7% on compensation in excess of $42,000 (5% plus 5.7%).

B. Under the new rules, the contribution rate for compensation in excess of the social security wage base may not exceed the rate contributed on compensation within the social security wage base by more than the lessor of the rate contributed on compensation within the social security wage basis or the employer OASDI tax rate for old-age insurance (currently 5.7%). Thus, in the above example, the maximum contribution on compensation in excess of the social security wage base would be 10% (5% plus 5%). If the contribution rate on compensation within the social security base were 6%, the maximum contribution on excess compensation would be 11.7% (6% plus 5.7%).

II Defined Benefit Plans -

A. Present Law

1. Offset plans. The present maximum offset based upon a calculation of the value of employer-provided social security benefits is 83 1/3% of the employee’s primary social

security benefit, with such rate reduced by ancillary benefits provided under the plan.

2. Excess plan. Similarly, in the case of excess plans the IRS has calculated that the employer-provided portion of social security benefits averages 37 1/2% of the average annual maximum wages on which social security benefits are based. Consequently, an excess plan will integrate if the plan provides a benefit up to 37 1/2% more on average final compensation in excess of the average compensation on which the social security benefit is based.

B. New Law

1. Offset plans. The maximum offset is the lessor of 50% of the benefit which would have accrued without the offset or 3/4% of the participant's average final salary times years of credited service not in excess of 35. Average final salary for this purpose disregards all compensation in excess of the social security wage base for each year.

2. Excess plans. The maximum excess allowance is the lesser of the base benefit percentage or 3/4% times years of credited service not in excess of 35.

III Observations

A. The integration limits are unrelated to actual social security benefits; do not permit employment with another employer to be taken into account; and will probably lower the limits in almost all cases. However, the calculations should be greatly simplified.

IV Effective Date - Plan years beginning after December 31, 1988.

Tax Section Seminar
New York State Bar Association
Laraine S. Rothenberg

I. EMPLOYEE STOCK OWNERSHIP PLAN

A. Distribution Requirements Act § 1174(b); Code § 409(o).

1. The plan must provide that unless a participant otherwise elects, distribution of the participant's account balance will commence not later than one year alter close of the plan year (a) in which participant separates from service by reason of attainment of normal retirement age under the plan, death or disability or (b) which is the 5th plan year after the plan year in which a participant otherwise separates from service. Code § 409(o)(1)(A)

2. Financed shares are excluded from the distribution requirements until the close of the plan year in which the loan is repaid. Code § 409(o)(l)(B).

3. Unless a participant elects otherwise, the distribution of an account balance must be in substantially equal periodic payments (not less frequently than annually) over not more than 5 years, or 5 years plus 1 year (but not more than an additional 5 years) for each $100,000 or fraction thereof by which such balance exceeds $500,000.

4. The distribution requirements apply to ESOPs and PAYSOPs. Act § 1174(b)(2); Code § 409(a)(3); Act § 1854(f)(3); Code § 4975(e)(7).

5. The distribution requirements are effective for stock acquired after December 31, 1986.

Questions

1. How do the new distribution requirements interact with Code section 411(a)(11) requiring consent for distributions in excess - of $3,500. See Treas. Reg. § 1.411(a)(11)-1T.

B. Modification of Put Option Act § 1174(c); Code § 409(h).

1. If a put option is exercised by a participant receiving a distribution from an ESOP or PAYSOP, the employer must pay the amount in substantially equal periodic payments (not less frequently than annually) over a period beginning not later than 30 days after exercise of the put option and not exceeding 5 years.

2. Reasonable interest must be paid on unpaid amounts and adequate security must be provided.

3. The put option requirements are effective for distributions attributable to stock acquired after December 31, 1986 but a plan may elect to apply these rules to all distributions after the date of enactment of the Act.

4. The put option and distribution requirements are extended to all stock bonus plans. Act § 1174(c)(2); Code § 401(a)(23).

C. New Qualification Requirement for ESOPS - Diversification Act § 1175; Code § 401(a)(28).

1. An ESOP or PAYSOP must give a "qualified participant" the right to elect within 90 days after close of each plan year in the "qualified election period" to direct the plan as to the investment of at least 25% of the participant's account in the plan.

2. The 25% minimum amount with respect to the diversification election is extended to 50%

in the year of a participant's last election.

3. The "Qualified Election Period" is the 5-plan-year period beginning with the plan year after the plan year in which a participant becomes a "Qualified Participant".

4. A "Qualified Participant" L an employee who has completed 10 years of participation and has attained age 55.

5. All valuations of employer security for purposes of this provision must be made by an independent appraiser if securities in an ESOP or PAYSOP are not readily tradeable.

6. The diversification requirements are met if the portion of an individual's account subject to the election is distributed to the individual within 90 days after the election period or if the plan offers at least 3 investment options pursuant to regulations to be prescribed by the Secretary.

7. Amounts distributed will qualify for rollover treatment as a partial distribution. Act § 1l22(e)(l); Code § 402(a)(5)(D)(i).

8. The diversification requirements are effective for stock acquired after December 31, 1986.

<u>Questions</u>

1. Can an employer satisfy the diversification requirements by distributing the portion of an individual's account subject to the election without the individual's consent or does the section apply only to distributions elected by a participant?

2. Can an employer extend diversification to all stock held by a "Qualified Participant" in the ESOP?

D. Sales of Employer Securities to ESOP or Worker Owned Cooperatives by Estates Act § 1172; Code § 2057 [Added New].

1. The value of the gross estate of a decedent is reduced by 50% of the "qualified proceeds" from the sale of employer securities by the executor of an estate to an ESOP or worker owned cooperative. Code § 2057(a).

2. Qualified proceeds include only proceeds received before the due date of the estate tax return (including extensions). The securities which are sold may not have been received as a distribution from a qualified plan or pursuant to the exercise of certain stock options. Code § 2057(c).

3. The securities sold to the ESOP or worker owned cooperative must not be allocated to the decedent's family (after attribution under Code section 267(b)) or a 25% owner of any class of securities of the employer. A prohibited allocation result in a 50% tax on the amount of the allocation, imposed on the employer. Act § 1172(b); Code § 4979A.

4. For the deduction to be allowed the executor of the estate must file a statement of the employer consenting to the application of the excise tax.

5. The sale must occur after the date of enactment of the Act and before January 1, 1992.

E. Miscellaneous Provisions

1. Dividend Deduction

In addition to the deduction available to corporations for dividends which are paid by ESOPs to employees, there will

be a deduction for dividends paid to an ESOP which are used to make payments on an acquisition loan. The provision applies to dividends paid after the enactment of the Act. Act § 1173(a); Code § 404(k)(2)(c).

2. Interest Exclusion

The 50% interest exclusion for loans to an ESOP will now be available to regulated investment companies. The provision applies to loans made after the date of enactment of the Act, including certain refinancing loans. Act § 1173(b); Code § 133(a)(4).

3. Securities Acquisition Loan

(a) The new definition of securities acquisition loan includes any loan to a corporation or ESOP to the extent the proceeds are used to acquire employer securities for the plan or used to refinance such a loan. The provision will apply to any loans which were used to refinance a loan which satisfied Code section 133(b)(9) when made and were used to acquire securities after July 18, 1984. In that case, the interest exclusion is applicable only for the first 7 years of the loan. Act §§ 1173(b)(2) and 1173(c)(2); Code § 133(b)(l).

(b) The definition also includes a loan to a corporation, if within 30 days, employer securities are transferred by the corporation to the ESOP, such securities are allocated to the accounts of plan participants within one year of such loan, and if the commitment period of such loan does not exceed 7 years. The amendment applies to loans made after the date of enactment. Act § 1173(b)(2); Code § 133(b)(l).

4. Early Distribution Tax

Distributions from an ESOP made before January 1, 1990 will not be subject to the early distribution tax to the extent that, on average, a majority of the plan's assets have been invested in employer securities for 5-plan-year period preceding the plan year of distribution and the distribution is attributable to assets which have been invested in employer securities at all times during such 5- year period. Act § 1123; Code § 72(t)(2)(C).

5. Reversion Tax

There is an exception to the tax on reversions to an employer of qualified plan assets for any amount transferred to an ESOP if, within 90 days of the transfer, the assets received are used to purchase employer securities or used to repay an acquisition loan. The securities acquired must be allocated to participants within 7 years and must remain in the plan until distribution under the plan to participants. At least half of the individuals who were participants in the qualified plan must be participants in the ESOP. The exception applies to amounts transferred to an ESOP after March 31, 1985 and before January 1, 1989 or after December 31, 1988 if the termination occurs after March 31, 1985 and before January 1, 1989. Act § 1132; Code § 4980(c)(3).

F. Technical Corrections

1. ESOP and PAYSOP Voting Act § 1854(f); Code § 409(e).

(a) A plan will meet the requirements relating to pass through of voting rights with respect to an issue if it permits one vote per participant and the trustee votes the shares held by

the plan in the proportion determined pursuant to such voting.

(b) The Act also requires pass through of voting rights, where the employer does not have a registration type of securities, with respect to the approval or disapproval of any corporate merger or consolidation, recapitalization, reclassification, liquidation, dissolution, sale of substantially all of the assets of a trade or business or such similar transactions as the Secretary prescribes in regulations, regardless of whether majority vote is required by charter or state law.

2. Nonrecognition of Gain on Sales to ESOPs Act § 1854(a); Code § 1042.

(a) Nonrecognition treatment under Code section 1042 applies to the sale of qualified securities to an ESOP only if the gain could have k e n long-term capital gain without the application of Code section 1042. Code § 1042(a).

(b) For the section to apply, the ESOP must own at least 30% of each class of outstanding stock or at least 30% of the total value of all outstanding stock after the sale. However, from July 18, 1984 to enactment of the 1986 Act in order to have nonrecognition treatment available an ESOP must own at least 30% of all employer securities or 30% of the value of all employer securities.

(c) Allocations of the securities subject to nonrecognition are prohibited to be made to the taxpayer making the election and family members for 10 years (from the date of sale to the ESOP or the date of plan allocation attributable to the final payment of

acquisition indebtedness incurred in connection with such sale, if later) and to 25% owner of employer securities at any time. Lineal descendants are exempt from prohibited allocation if no more that 5% of securities sold to the ESOP are allocated to all lineal descendants. A prohibited allocation results in income in the amount of the allocation to the person, relative or 25% owner in the year of allocation and a 50% tax on the employer. Act § 1854(a)(3)(A); Code §§ 4979A [Added New] and 409(n).

(d) The qualified replacement property cannot be securities of:

a. a corporation with passive investment income of more than 25% of its gross receipts and a corporation sponsoring the ESOP or in the same controlled group;

b. a corporation with more than 50% of assets not used in active conduct of trade or business (except financial institutions or insurance companies); or

c. a government or political subdivision thereof.

II. PAYSOP

A. <u>Payroll Based Stock Ownership Plan - Tax Credit Repeal</u> Act § 1171(a) & (c); Code § 41.

1. The tax credit is repealed effective with respect to compensation paid or accrued after December 31, 1986 in taxable years ending after that date.

2. The 84 month rule will not apply to distributions upon termination of a PAYSOP after December 31, 1984. Act § 1174; Code § 409(d)(1).

B. <u>Alternatives to employer.</u>

1. Terminate the plan and trust and distribute the assets to employees. The tax consequences of an in service distribution must be considered. In general, 5 year averaging is available only if a participant is over 59-1/2 and the balance to the credit of the participant's account is distributed. An early distribution tax of 10% may apply to the taxable amounts distributed before age 59 1/2 and not rolled over into an IRA or qualified plan.

2. Retain the trust and terminate contributions to the plan. Distributions can be made on separation from service, death or disability.

3. Convert the plan to an ESOP or transfer the assets in the PAYSOP to another qualified plan.

III. UNREALIZED APPRECIATION Code §§ 402(e)(4)(J) and 402(g)

A. The Act allows participants, to the extent provided by the Secretary of the Treasury, to elect before any distribution to include in gross income amounts which would normally go untaxed as unrealized appreciation. Act § 1122(g); Code § 402(e)(4)(J).

B. If a plan trustee exchanges a plan's employer securities or disposes of employer securities and uses the proceeds to acquire other employer securities within 90 days, there will .be no effect on the basis of the employer securities as a result of the transaction. The section applies to transactions occurring after December 31, 1984. However, for transactions occurring prior to January 1, 1987, the reinvestment period does not end before the earlier of 1 year after the date of transaction or 180 days after enactment. Act § 1854(g); Code § 402(g) [Added New].

IV. AMENDMENT DEADLINES Act § 1140.

A. If amendments to the Code require plan amendments, such plan amendments will not be required until the first plan year beginning on or after January 1, 1989, if at all times after the Code amendment, the plan is operated in accordance with such Code amendment and such plan amendment applies retroactively to the effective date of the Code amendment.

B. For collectively bargained plans ratified before March 1, 1986 the plan amendment is not required until the first plan year beginning after the later of January 1, 1989 or the date the agreement terminates, but in no event later than the first plan year beginning on or after January 1, 1991.

V. FORFEITURES Act § 1119; Code § 401(a)(8).

A. Money purchase plans are treated like other defined contribution plans and forfeitures can be reallocated to other participants or used to reduce employer contributions or administrative costs. The Act amends 401(a)(8) effective for plan years beginning after December 31, 1985.

VI. VESTING Act § 1113; Code § 411(a)(2).

A. Vesting must be as rapidly as 5-year cliff or 7-year graduated (20 percent after 3 years and additional 20 percent each year thereafter).

B. Multiemployer plans may apply 10-year cliff vesting to individuals covered under collective bargaining agreements.

C. Class year vesting is repealed.

D. Present law allowing eligibility to be conditioned on 3 years of service k changed so that no more than 2 years can be required. However, if 2 years are required then there must be immediate vesting.

E. The provisions are effective for plan years beginning after December 31, 1988, with a special later effective date for collectively bar gained plans.