Private Pensions: 1982 Legislation

by Gene Carter*

In August 1982, Congress passed the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA). This new law included several provisions that affected private pension plans and benefits. The pension-related provisions fell into three main groups which (1) rolled back the annual limitations on maximum benefits and contributions that must be observed if a pension plan is to qualify for favorable tax treatment; (2) established a new set of requirements that pension plans must meet to receive favorable tax treatment when they benefit company officials or management excessively (top-heavy plans); and (3) liberalized many restrictions that applied to pension plans for individual businesses, partnerships, and closely held corporations, while also establishing other new restrictions for them. This article examines the private pension rules prior to the passage of TEFRA and describes the ways in which the rules were changed.

Since the Social Security program was enacted nearly 50 years ago, experts on social insurance programs have debated the role framers of the program intended for Social Security to play in the Nation's retirement system. On one hand, some view Social Security as the principal source of retirement income for the majority of American workers. Under this view, additional retirement income from sources such as individual savings or private corporate pension plans would be available to a relatively small part of the retired population and would supplement the Social Security benefit. Others view Social Security benefits as a basic floor of retirement income protection that is expected to be augmented by most retired workers with individual savings or private pensions. Regardless of the particular viewpoint one holds, there is general agreement that the availability of private pension income during retirement is highly desirable, not only from the standpoint of increased income for retired workers, but also in terms of the moderating influence the availability of a pension benefit may have on pressures to raise and expand Social Security benefits.

Congress has shown its recognition of the value of private pension coverage and benefits in its legislative treatment of pension plans by offering both individual plan participants and sponsoring companies favorable plan-related tax treatment that excludes from current taxable income contributions to pension trust funds and interest earned on trust fund investments. However, the Congress has also conditioned the continuance of favorable plan-related tax treatment to the plans continuing to meet a series of plan requirements. These requirements have usually had as their goals the broadening of coverage under pension plans to rank and file employees in low and middle compensation ranges and increasing assurance that such employees who performed specified periods of covered service receive some benefits from the plans when they retire. Plans that meet these requirements and, as a result, continue to receive favorable tax treatment related to plan finances are known as "qualified plans."

Private pension plans have received favorable tax treatment since 1926, when pension trust funds exclusively established for all or some company employees were exempted from Federal income tax. At the same time, employer contributions to trust funds on behalf of workers were treated as a payroll cost and therefore excluded from the employer's taxable income. Workers, in turn, were not taxed on contributions made to the trust funds by employers on their behalf, or on interest earned by those contributions, until they were actually paid out as benefits.

By the early 1940's, however, it was apparent that pension-related tax advantages were not being used to the advantage of all workers. Because the pension trust funds could cover "some" as well as "all" employees,

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plans were being established that covered and benefited only the officers and management personnel of many companies. These restricted plans enabled such individuals to avoid or defer taxation on a substantial part of their income. Therefore, in 1942, Congress passed the first in the series of employee protection requirements to be met by pension plans if they were to continue to receive favorable tax treatment. Under the 1942 law, to be designated a "qualified plan," a pension plan had to meet the following requirements: (1) the plan had to be for the exclusive benefit of workers or their beneficiaries; (2) the plan had to exist for the purpose of distributing earned or accumulated benefits and their earnings to the workers; (3) the employer could not use or divert the pension plan trust fund until the plan's liabilities to workers and their beneficiaries were met; and (4) the plan could not discriminate in favor of company officials, management, or highly compensated employees in its coverage. It was through the nondiscrimination requirement that Congress sought to eliminate the existing tax abuses and substantially broaden the base of private pension coverage to lower paid employees.

Between 1942 and 1974, no legislative changes were made in the requirements plans had to meet in order to be ruled a "qualified plan." (There were, however, many Internal Revenue Service (IRS) regulatory changes within the framework of the 1942 legislation, and in 1962 Congress extended favorable tax treatment to plans that covered the owners of sole proprietorships and partnerships.) The long period of legislative inactivity came to an end in 1974, with the Employee Retirement Income Security Act of 1974 (ERISA). The passage of ERISA followed a decade of public discussion of the private pension system and its successes and failings. The new requirements for "qualified plan" status introduced by ERISA were intended to preserve the private system's successes and at the same time remedy what were viewed as the most serious of the system's failures. The shortcomings addressed included (1) the exclusion of many workers from coverage as a result of individual plan coverage provisions; (2) the loss of entitlement to benefits by many workers as a result of breaks in service or termination of employment; (3) the precarious financial condition of some pension plan trust funds and instances of abuse in pension fund investment policies; and (4) favoritism in the treatment of high-paid, compared with low-paid, employees under plans.

Each of these four areas was addressed by one or more provisions of ERISA, all of which had to be met for a plan to be designated a "qualified plan." The relevant ERISA provisions included mandated uniform requirements for coverage and vesting (the acquired right to benefits), several provisions to strengthen and protect pension trust funds, and a series of new limitations on plan contributions and benefits that were intended to eliminate the disproportionate tax advantages being realized by company officials, management, and highly compensated employees.

Before the imposition of these limitations, it was not unusual for companies and their highly paid employees and officials to benefit from substantial pension-related tax advantages even though their pension plans still met the "qualified plan" requirements. Basically, this was accomplished by making very large pension contributions on behalf of such individuals or toward large future benefits payable to such individuals, thus reducing the taxable income of both the company and the individuals. By capping the annual amount of benefits and contributions that could be made for individuals by "qualified plans," tax advantages were lowered and differences in the distribution of pension-related tax advantages between highly compensated employees and rank and file workers became smaller.

As a result of ERISA, benefits payable under defined benefit plans (those plans that specify either the benefits to be received at retirement or the method of determining the benefits) were limited to the smaller of $75,000 a year or 100 percent of the worker's average compensation for the three highest consecutive years when he or she was covered by the plan. Contributions to an employee's account under a defined contribution plan (those plans that set contributions and which generally base benefits on the contributions and their earned interest accumulated for each individual worker) were limited to the smaller of $25,000 a year or 25 percent of the employee's annual compensation.

The law provided that the annual limits for both types of pension plans would be adjusted each year to allow for increases in the cost of living. The cost-of-living adjustments were to be made under Internal Revenue Service (IRS) regulations following procedures similar to those used in making cost-of-living adjustments in Social Security benefits.

When a company maintained both a defined benefit and defined contribution plan covering the same employees, a special rule applied to determine the allowable combined annual limitation applicable to each employee. In its simplest terms, the annual defined benefit payable, plus the annual defined contributions payable, each expressed as a percentage of their respective allowable limitation, could not exceed 140 percent. If, for example, the annual defined benefit payable at retirement was equal to 80 percent of the allowable limitation, the payment to the defined contribution plan could not exceed 60 percent of the allowable limitation for defined contribution plans. If the 140-percent figure was exceeded, one of the plans would lose its status as a "qualified plan."

One more ERISA provision relating to limitations should be noted. When payments under a defined benefit plan were scheduled to begin before age 55, the benefit was to be adjusted to determine the actuarial equivalent of an annual lifetime benefit beginning at age 55. When testing to determine whether the $75,000 annual limitation was met, this adjusted annual benefit was to be used in place of the actual benefit. Thus, total lifetime benefits could not exceed those ordinarily permitted under the annual limitation by paying some of the total lifetime amount as an early retirement benefit.

Changes in Annual Limitations

By 1982, as a result of progressive inflation over the years and of larger than anticipated price increases, the year-to-year application of the cost-of-living adjustment to the maximum annual benefit and contribution permitted under qualified plans had substantially increased these limits. The maximum annual benefit permitted under defined benefit plans had risen from the $75,000 established under ERISA to $136,425. The annual maximum contribution under defined contribution plans had risen from $25,000 to $45,475. As a result of these increases, companies and their highly paid employees and officials were receiving larger tax advantages (and the U.S. Treasury was losing more revenue) than many felt to be desirable. Accordingly, in passing the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), Congress included in the legislation several provisions that changed the annual benefit and contribution limitations.

First, the 1982 maximums were rolled back. Beginning in 1983, for existing plans (or from their onset for plans established after July 1, 1982) the annual maximum benefit permitted under a qualified defined benefit plan was cut to $90,000. For defined contribution plans, the annual maximum contribution was dropped back to $30,000. This action made permanent roughly one-fourth of the 1972-82 increase in the maximums for both types of plans but eliminated the rest.

These rollbacks in annual limitations applied only to the dollar amounts of the limits. The alternative limits of benefits equal to 100 percent of compensation or contributions equal to 25 percent of compensation were left unchanged and were still applied if they were less than the specified dollar ceilings.

In addition to reducing the benefit and contribution limits that must be met by "qualified plans," Congress took several other steps to control pension-related tax advantages. First, the automatic cost-of-living adjustment in the annual limitations was suspended until 1986, freezing the limits at the new 1982 levels. Plan participants who had already become entitled to defined benefits in excess of the new $90,000 limit were permitted to retain the higher benefits, but the benefits could not be adjusted upward for any reason until the defined benefit limit caught up to their existing benefit level. This cannot happen until at least 1986, at which time the limits will be adjusted for post-1984 cost-of-living increases, using the Social Security benefit adjustment.

In another change, the age at which the defined benefit annual limit must be adjusted when testing to see whether the annual dollar limit is met was increased from age 55 to age 62. Under the new law, when benefits begin before age 62 the current benefit limitation is actuarially reduced to the dollar limit for benefits beginning at age 62. This limit is not reduced, however, to be less than $75,000 for benefits beginning at age 55 or over, or the actuarial equivalent of a $75,000 annual benefit for benefits beginning before age 55. The resulting annual equivalent is compared with the benefit to see if the limitation is met. This provision will limit further tax advantages resulting from the payment of early retirement benefits.

On the other hand, the law provided a new upward adjustment of the dollar amount limit for defined benefits when retirement begins after age 65. In this way, total expected lifetime benefits under the higher adjusted limit would be equivalent to those permitted under the regular annual limit if benefits began at age 65.

The 1982 legislation also changed the fraction that could be used when participants are covered under both a defined benefit and defined contribution plan. Under the previous law, the sum of the dollar amounts or percentage of compensation (whichever was used) under the two plans, each expressed as a percentage of their respective limits, could not exceed 140 percent. Under TEFRA, when dollar amounts are used in making the combined compliance test, the allowable percentage is reduced to 125 percent. The new provision applies only with respect to the dollar limit test; the percentage of compensation test remains at 140 percent. However, the expectation is that the dollar amount limitation will almost always constitute the operational limits in practice.

TEFRA also made an important clarification in the former law. Before TEFRA, it was not clear whether the dollar limits applicable to future defined benefit plan benefits were those in effect in the year the contribution was made to finance the future benefit or those projected to be in effect the year the benefit was actually paid. TEFRA resolved the issue by providing that a company cannot deduct amounts from its taxable income that are contributed to finance future pension benefits if the benefits payable in the future year exceed the current year's annual limitation. However, current deductions can be made for benefits that, because future salary increases are assumed, will be higher than those being paid today, so long as these projected future benefits still lie within the current dollar limit for defined benefits.

Changes in Noncorporate Plans

Besides corporate pension plans, there are other kinds of employer-sponsored retirement plans that can qualify for tax advantages. These "noncorporate" plans, which cover the employees and owners of single proprietorships and partnerships, are known as HR-10 or "Keogh" plans. In addition there is another group of special plans that were subject to essentially the same provisions. These plans, known as Subchapter S plans, cover the employees and officials of small closely held corporations (10 or fewer stockholders). To simplify the following discussion of these two types of plans, they will be collectively referred to as Keogh plans, even though technically the Subchapter S plans are a separate category.

Keogh plans had their origin in the Self-Employed Individuals Tax Retirement Act of 1962, which extended the availability of "qualified" private pension plans to proprietorships and partnerships that covered the owners in their pension plans. As in the case of corporate plans, the Congress wrote into the law certain tax advantages, subject to qualifying requirements, to encourage owners to establish Keogh plans for their employees, as well as themselves, thereby broadening the base of private pension coverage.

The "qualified plan" requirements for Keogh plans include a set of annual limitations on contributions that must be observed to receive favorable tax treatment.[1] Before 1982, however, these limits were much lower than those established for corporate plans. Under the original Keogh legislation, contributions were limited to $2,500 a year or 10 percent of the owner's annual income, whichever was lower. Just before the passage of TEFRA, the limit had grown to the lower of $15,000 or 15 percent of salary, still well below the applicable corporate plan limit. TEFRA extended to Keogh plans the more liberal limits for "qualified" corporate plans. In addition, certain more restrictive coverage rules were eliminated and replaced by the regular corporate plan coverage provisions. Also, all Keogh plans can now integrate with Social Security on the same basis as corporate plans.

Two sets of Keogh plan rules were extended by TEFRA to cover all plans. These were the rules for qualified distributions and the method of integrating defined contribution plans with Social Security. The new law provides that the distribution of benefits under all "qualified plans" must begin by the later of the tax year in which the plan participant attains age 70 1/2 or the year in which the participant actually retires. The new integration rule, now applicable to all defined contribution plans, reduces the difference between the contribution rate allowed for compensation above and below the Social Security wage base from 7 percent to the current Old-Age, Survivor, and Disability Insurance (OASDI) employer tax rate. The effect of this change is to narrow the gap between the allowable contribution rate on highly compensated employees and the allowable rate for all other employees under all defined plans.

Finally, TEFRA extended to all defined benefit and defined contribution plans a modified set of Keogh plan rules that would be applied to plans that primarily benefited owners and key employees. These new rules for "top-heavy plans" will be discussed in the following section. The net result of these changes was to make all corporate and Keogh pension plans subject to almost the same set of rules and limitations in order to be designated a "qualified plan."

New Rules for Top-Heavy Plans

One of the most significant changes made by TEFRA was the introduction of a special set of requirements that must be met if a plan is to continue as a "qualified plan" when a plan is found to primarily benefit a company's key employees. These special rules represent a modification of a set of rules that previously applied only to Keogh plans.

Under TEFRA, a plan found to primarily benefit key employees is referred to as a "top-heavy" plan. Beginning in 1984, a plan will be determined to be top-heavy if the plan's accrued benefit values for key employees exceed 60 percent of the accrued benefit values for all employees covered (accrued benefit values will be measured in terms of benefits for defined benefit plans and account balances for defined contribution plans). A plan will also be considered top-heavy if it is part of a group of plans maintained by a company, or two or more related companies, in which the total accrued benefits for the key employees covered by the plans exceed 60 percent of the benefits for all employees covered.

Key employees are defined by TEFRA as those who are (1) officers, (2) the 10 employees who own the largest interest in the company, (3) owners of 5 percent or more of the company, or (4) owners of at least 1 percent of the company who are receiving over $150,000 in annual compensation. In large companies, the maximum number of officers who have to be counted as key employees is 50. In smaller companies, the maximum is the larger of three persons or 10 percent of the total number of employees. Under the law, the term officer is generally accepted in the usual corporate context, that is, an administrative officer who is in regular and continued service.

For any plan-operating year in which a plan is top-heavy, the special requirements must be met if the plan is to retain its "qualified plan" status. Usually the date for making such a determination is the last day of the previous plan year. The special top-heavy plan requirements fall into four main areas: (1) limits on compensa-

[1] Keogh contribution limits applied only to owner-employees and self-employed individuals in Keogh plans. Common law employees covered by Keogh plans were subject only to the regular corporate plan limits.

tion included under the plan, (2) a special vesting schedule for non-key employees, (3) minimum non-integrated benefits and contributions for non-key employees, and (4) lower combined annual limits for benefits and contributions for key employees covered by both a defined benefit and a defined contribution plan.

Limitation on Compensation

For top-heavy plans, only the first $200,000 of any employee's annual compensation can be used in computing pension benefits. The imposition of this limit can result in the payment of pension benefits to highly compensated employees substantially below the benefits under the regular annual limitations allowed for both defined benefit and defined contribution plans. The special top-heavy plan compensation limit will be subject to the same cost-of-living adjustment as the regular annual defined benefit and defined contribution plan limitations, beginning 1986.

Vesting Schedule

Plans that have been top-heavy must implement an accelerated vesting schedule. The benefits vested under the accelerated schedule must include all benefits accrued under the plan, not just those accrued while the plan is operating under the special top-heavy rules. Top-heavy plans may choose from one or two special vesting schedules.

Under the first alternative, plan participants must be 100-percent vested after 3 years of service. Plans choosing the alternative must open plan participation to all employees aged 25 or older with 3 years of service with the company. (This vesting and participation combination existed prior to TEFRA as one of the optional vesting schedules available to plans.) Under the second alternative, graded vesting without regard to age is permitted. Twenty percent of the employee's accrued benefits must be vested after 2 years of service, with an additional 20 percent becoming vested each year until 100-percent vesting is reached after 6 years.

The regular rules for counting company service apply in counting years of service under either of the special top-heavy plan accrual schedules. Thus all years of company service are generally taken into account, whether or not the top-heavy plan rules were in effect.

Minimum Benefits and Contributions

For years in which a plan is deemed to be top heavy, the plan must meet specified minimum levels for every non-key employee covered by the plan (or excluded only because the plan is integrated and their compensation was below a specified amount). The specified minimum benefit or contribution may not be reduced or eliminated by Social Security benefits based on the employer's share of Social Security contributions. Therefore, the top-heavy minimums are said to be nonintegrated.

For each year a defined benefit plan is top heavy, each non-key employee must generally accrue a benefit equal to 2 percent of the employee's average compensation for the highest 5 years of service times his or her years of service. The highest minimum benefit does not have to exceed 20 percent of annual compensation. This means that the minimum benefit formula really amounts to 2 percent of compensation times 10 (or fewer) years of service. Years before 1984 or in which the plan was not top heavy can be excluded from the compensation averaging period.

For each year a defined contribution plan is top heavy, the employer must generally make a contribution on behalf of each non-key plan participant equal to at least 3 percent of the employee's annual compensation. However, if a smaller percentage is contributed on behalf of the key employee receiving the highest percentage distribution of benefits from the plan, that smaller percentage then becomes the minimum contribution. In computing the limiting percentage for the top key employee, the annual compensation used as a base cannot exceed $200,000. If an employee is covered by both a defined benefit and a defined contribution plan, only one of the special top-heavy minimums needs to be provided.

Combined Benefit-Contribution Limitation

When a top-heavy plan is involved and an employee is covered by both a defined benefit and a defined contribution plan, the limiting fraction for the combined dollar amount maximums permitted is reduced from 125 percent for regular qualified plans to 100 percent for top-heavy plans. However, this special rule can be set aside when a "concentration test" is met and when an extra minimum benefit is provided to non-key employees. What this means in operational terms is that (1) if the accrued benefit values for key employees do not exceed 90 percent of the total accrued benefit values and (2) the special minimum benefits are raised to prescribed levels, the lower combined limit does not apply.

Distribution Rules

Two other rules, relating to the distribution of plan benefits, also apply when a plan is determined to be top heavy. First, key employees under age 59 1/2 who began to receive plan benefits accrued while they were key employees will be assessed a 10-percent surtax on these benefits. (The surtax does not apply if payments are made because of death or disability.) Second, the distribution of benefits to key employees cannot be delayed past age 70 1/2, even if the employee continues to work.

Other Pension-Related Changes

Besides these major revisions, TEFRA also made other changes that were of somewhat less importance or that affected smaller groups or special kinds of pension plans. Some of these changes are briefly described in the following sections.

Liberalizations of Simplified Employee Pensions

Qualified plan requirements for Simplified Employee Pensions (SEP's) were liberalized appreciably to make these benefits more appealing to employers through greater plan-related tax advantages, thereby promoting wider use of these plans. Under such plans, employers utilize an IRA contract to provide their employees with employer-financed pension coverage, thus avoiding much of the paperwork associated with Keogh or regular corporate plans. At the time of SEP's origination in 1979, employers were permitted to make tax deductible contributions to a SEP on behalf of their employees in the amount of the smaller of $7,500 or 15 percent of total compensation. To be designated an approved or qualified plan, a SEP had to meet a number of specified plan requirements.

Liberalizations of SEP's under TEFRA included raising the limit for the maximum annual contribution to $30,000. Beginning in 1986, the limit will be subject to the same cost-of-living adjustments as are the limits for other types of plans. In addition, TEFRA dropped the requirement for a minimum contribution of 7.5 percent where compensation in excess of $100,000 is taken into account, and provides instead for a uniform relationship to total compensation, but not in excess of $200,000.

Lower Tax Exemptions for Loans From Plans

Before the passage of TEFRA, qualified pension plans and tax-sheltered annuities were generally permitted to make "reasonable" loans to participants. The proceeds of such loans were not subject to taxation at the time they were paid. Under the provisions of TEFRA, beginning in August 1982, loans made thereafter became taxable income, except for the part of the loan that falls within certain specified limits. The tax exempt amount includes the amount of the loan, plus any outstanding prior loan balance, to the extent that this sum does not exceed the lesser of $50,000 or 50 percent of the borrower's vested accrued benefits under the plan (but not less than $10,000). In addition, the terms of the loan must call for its repayment within 5 years unless the loan is for the purchase, construction, or repair of the principal residence of the borrower or a member of his family. Loans that remain unpaid after 5 years, other than the exempted residential loans, or for which repayment is extended, beyond 5 years, regardless of reason, will be treated as benefit distributions under the plan and will be subject to applicable tax rules.

Affiliated Organizations and Employee Leasing

TEFRA expanded and tightened the rules impacting on pensions plans to require more coverage of rank and file workers when separate but affiliated companies perform management and service functions, or employee services are provided under contracts with employee leasing organizations.

Conclusion

Taken together, the private pension changes made by TEFRA reflect a significant statement of congressional private pension policy. First, they show continued adherence to the policy of encouraging the extension of coverage to segments of the workforce not presently covered by pension plans through the use of generous tax treatment of certain types of plans. Second, the commitment that pension plans benefit rank and file workers in a company, to at least some specified level, was reaffirmed by the imposition of tighter qualifying conditions that plans must meet and new restrictions on the extent to which plans can benefit highly compensated employees and officials. Finally, TEFRA reduced somewhat revenue losses to the Treasury by scaling back the previous ceilings on contributions on behalf of, or benefits to be paid to, the highest paid workers.