THE TAX REFORM ACT OF 1984

The Tax Reform Act of 1984, the revenue component of the Deficit Reduction Act, in addition to provisions addressing industrial revenue bonds, real estate depreciation, liquor taxes, foreign trade rules and a variety of accounting and tax shelter reforms, contains more than 40 provisions that apply to employee benefits. Some changes will ease restrictions imposed by TEFRA in 1982, such as distribution requirements and top-heavy rules. Others will pose additional problems, such as stricter 401(k) rules and an extention of the freeze on contribution and benefit limits.

Funded welfare benefit plans, including Voluntary Employees' Beneficiary Associations (VEBAs), will face an entirely new set of rules intended to limit the build-up of tax-free reserves. Cafeteria plans will be limited to a narrower choice of benefits and will have tougher discrimination rules, though the retroactive application of Treasury's restrictive regulations has been eliminated.

Here are some of the other changes that will affect employee benefit programs.

Nontaxable Fringe Benefits

Several new categories of statutory nontaxable fringe benefits have been created. The new rules are intended to end an ongoing controversy over Treasury Department efforts to tax certain fringe benefits under administrative rules published by Treasury. That controversy led to a legislated moratorium on such rules which has since expired. Benefits that do not fit into these new categories and which are not specifically addressed elsewhere in the tax code will be subject to both payroll and income taxes:

- No-additional-cost services, such as stand-by airline passes. Generally, these must be provided in the line of business in which the employee works, though a grandfather rule has been added to the line-of-business limitation to protect arrangements in effect at the beginning of 1984.

- Qualified employee discounts. Employees can get tax-free discounts up to the employer's gross profit percentage on merchandise or up to 20 percent of the selling price on services. A line-of-business rule will limit the type of discounts an employee can get, subject to a grandfather provision.

- Working condition fringes. Property of services that would be deductible as ordinary and necessary business expenses if the employee had paid for them will be excluded from income. However, the tax-free use of a demonstration automobile is limited to full-time auto salespersons, and is not available to other employees of the dealership.

- De minimis fringes whose fair market value is so small that accounting would be impractical. The typing of a personal by a company secretary or occasional company parties or picnics will not be taxed, for example. The frequency with which such benefits are provided is to be taken into account in assessing whether the value is excludable from income.

- Qualified tuition reductions for employees of educational institutions and their families. Only tuition for education through the college level can be paid for under this exclusion.

- Athletic facilities operated by the employer for use of its employees and their families.

Nondiscrimination rules apply to no-additional-cost services, employee discounts and tuition reductions. They do not apply to free parking or other working condition fringes and athletic facilities, nor to de minimis fringes other than subsidized eating facilities.

In establishing the above categories of tax-free benefits, Congress has directed the Treasury Department to issue regulations to implement the new law and to establish the manner in which payroll taxes are to be collected on non-cash fringe benefits.

Distribution Rules

Distribution rules for qualified plans will be eased somewhat to accommodate a wider variety of situations:

- Joint and survivor annuity payments to a participant and a non-spouse beneficiary will be permitted.

- If a participant dies before benefit payments begin, the surviving beneficiary can receive benefits in the form of a life annuity, whether or not the beneficiary is the participant's spouse. Payments can also be made over the survivor's life expectancy period.

- If a participant dies after benefit payments have begun, payments to the beneficiary must be at least as rapid as if the participant had not died. For example, if a participant elects to receive benefits over a period of 20 years and dies 10 years after the payments begin, the survivor will have to receive benefits within 10 years of the participant's death.

- The additional 10 percent income tax on distributions prior to age 59-1/2 in top-heavy plans will apply only to the extent that the distribution is attributable to years in which the participant was a five percent owner, whether or not the plan was top-heavy for those years.

- Distributions to a five percent owner must begin by age 70-1/2, even though the employee has not retired by that time, regardless of whether or not the plan is top-heavy.

401(k) Plans

A plan will be treated as a qualified cash or deferred arrangement, or 401(k) plan, only if it satisfies the Actual Deferral Percentage (ADP) tests for such plans. The tax legislation thus overrules

language in Treasury's proposed 401(k) regulations that would have allowed a plan to be treated as a 401(k) plan by passing the general nondiscrimination tests for qualified plans. That language implicitly would have permitted the sponsoring employer's Social Security contributions to be taken into account in determining if a plan is a 401(k) plan. In addition, the bill will affect the practice of establishing a separate 401(k) plan for certain groups of rank and file employees in order to use the general nondiscrimination rules to satisfy 401(k). In contrast, the legislation confirms the position in the proposed regulations that employer contributions to a 401(k) plan can be taken into account in applying the ADP tests if those conditions satisfy the vesting and withdrawal rules applicable to elective 401(k) contributions.

Separate 401(k) arrangements maintained by an employer as part of two or more conventional qualified plans will have to be aggregated in applying the ADP tests if the plans otherwise must be aggregated under the "comparability" rules to be qualified. Under those rules, an employer may designate separate plans as a single plan for purposes of applying the coverage and nondiscrimination rules applicable to conventional qualified plans.

If a plan is not considered a 401(k) plan because it fails to satisfy the ADP tests, elective contributions are treated as nondeductible employee contributions. The plan may still be treated as a conventional qualified plan if it meets the qualified plan requirements.

Additional Changes

Also included are:

- Congress failed to extend the income exclusion for educational assistance benefits, which expired at the end of 1983. Pre-1978 law will again apply to these programs, so employees must pay income tax on any educational assistance not directly related to their jobs.

- The definition of "key employee" in top-heavy pension plans will be changed to exclude officers who earn less than 1.5 times the

dollar limit on contributions to defined contribution plans. Thus an officer earning less than $45,000 in 1984 would not be considered a key employee. A Senate proposal to repeal the special super top-heavy rule was dropped.

- The pension plan contribution and benefit limits under section 415 will be frozen at their current levels ($30,000 and $90,000) for two more years. The next adjustment will not be until 1988. (See the December 1983 issue of The Employee Benefits File for a full discussion of the implications of extending the freeze of the section 415 limits.) Similarly, the scheduled increases in the tax credit for payroll-based employee stock ownership plans (PAYSOPs) will not occur. The credit will remain at 0.5 percent of aggregate compensation through 1987.

- Medical benefits provided under a defined benefit pension plan will be treated as contributions to a separate defined contribution plan and will count toward the section 415 combined plan limits. Individual medical benefit accounts must be kept for each five percent owner under a defined benefit or other qualified plan offering post-retirement medical coverage, and benefits for each five percent owner must come only from that account. Ordinary health insurance for employees will not be affected.

- Retirees will have to pay tax on group term life insurance in excess of $50,000, and nondiscrimination rules that now apply to life insurance for employees will be extended to include retirees.

- New rules will encourage employee stock ownership plans (ESOPs). The changes, mostly complex tax and accounting modifications, in some circumstances allow deductions to a company for dividends paid with respect to stock held by an ESOP.

- Tax-free rollovers of partial distributions from qualified plans to Individual Retirement Accounts (IRAs) will be allowed, but

subsequent distributions from the plan that made the partial distribution will not be eligible for 10-year averaging.

- Any withdrawal liability incurred by an employer under the Multiemployer Pension Plan Amendments Act of 1980 because of a withdrawal from a multiemployer plan before September 26, 1980 is declared void. A plan that collected liability payments because of such withdrawals is required to return the money to the employer with interest.

- Congress has repealed the $100,000 estate tax exclusion for benefits under qualified plans, tax-sheltered annuities and IRAs.

New Requirements for Cafeteria Plans

The new tax legislation also sets forth new cafeteria plan requirements:

- Benefits that can be provided under a cafeteria plan will be limited to cash and fringe benefits specifically excluded from income tax under the Internal Revenue Code, such as health care, disability insurance, dependent care, legal services and group term life insurance. In addition, the new law precludes a cafeteria plan from providing certain nontaxable benefits such as scholarships, parking and vanpools.

- Key employees participating in a cafeteria plan will be taxed as if they had received all taxable benefits available if more than 25 percent of the total nontaxable benefits are provided to key employees. For this determination, nontaxable benefits will be considered to be provided to key employees based on the value of coverage, rather than expense reimbursements. The new utilization test will supplement, not replace, the nondiscrimination requirements already included in section 125. For purposes of the test, the term "key employee" has the same meaning as under the top-heavy requirements applicable to qualified retirement plans.

- o According to the conference report accompanying the legislation, vacation days can be offered as a cafeteria plan benefit only if unused vacation days can not be cashed in or rolled over to a later plan year.

- o New reporting requirements will be established for cafeteria plans.

The new cafeteria plan requirements established by the tax law will take effect January 1, 1985.

Restrictions on Reserve Levels for Welfare Plans

The new tax law will limit deductible employer contributions to funded welfare benefit plans (VEBAs), other tax-exempt welfare trusts and certain experience-rated insured funds) to amounts needed to provide current benefits and fund limited reserves. Actuarial certification will be required for reserve levels exceeding certain safe harbors. An unrelated business income tax will be imposed in the case of a tax-exempt welfare fund that exceeds permitted reserve limits. In addition, an excise tax of 100 percent will be imposed if any funds revert to the employer.

The limitations and safe harbors for reserve levels specified in the legislation are:

- o Long-term disability - Reserves may include only amounts needed to fund incurred but unpaid claims and associated expenses, and they may not include amounts for benefits exceeding the lower of 75 percent of pay or the defined benefit pension limit (i.e., $90,000 in 1984). The Treasury Department will set the safe harbor limit.

- o Short-term disability - Reserves may only include amounts needed to fund incurred and unpaid claims and associated expenses. The safe harbor will be 17.5 percent of prior year benefits plus administrative costs.

- Medical coverage for active employees - Reserves may only include amounts needed to fund incurred but unpaid claims and associated administrative expenses. The safe harbor will be 35 percent of prior year benefits plus administrative costs.

- Retiree medical coverage - Deductions will be allowed for contributions used to prefund this coverage on a level basis over the working life of employees, if plans (1) meet nondiscrimination requirements, (2) use actuarial assumptions based on current medical plan costs and (3) use reasonable and consistently applied actuarial cost methods. Safe harbors will be defined by Treasury regulations. Separate accounts will be required for key employees, and contributions for key employees will count toward the section 415 pension limits. An excise tax equal to 100 percent of disqualified benefits will be imposed on plan sponsors if certain nondiscrimination requirements are not met or if key employees receive coverage from funds set aside for other employees. In addition, no reserves for retiree medical benefits will be exempt from the unrelated business income tax. In effect, prefunding of such benefits will be treated as if the trust were a taxable entity.

- Life insurance - Reserves may not exceed the level needed to fund incurred but unpaid claims and a retired lives reserve (RLR). The funding of the RLR must meet the requirements set by published revenue rulings and may not exceed the amount needed to provide tax-free insurance (up to $50,000) to retirees. Safe harbors will be defined by Treasury regulation. Like retiree medical benefits, if certain nondiscrimination requirements are not met or key employees received coverage from funds set aside for other employees, an excise tax will be imposed.

- Supplemental unemployment benefits and severance pay - Reserves will be limited to 75 percent of average annual benefits plus administrative costs during any two of the preceding seven years. Reserves may not be established for annual benefits in excess of

1.5 times the contribution limit under a defined contribution pension plan (i.e, $45,000 in 1984).

Collectively bargained plans will be subject to special reserve limits to be defined by Treasury regulations no later than July 1, 1984. For all other plans, there is a four-year phase-in period to alleviate the problem of currently excessive reserves. In the first year, the permitted level of reserves will include an additional amount equal to 80 percent of the excess reserve, decreasing to 60, 40 and 20 percent in succeeding years.

A tax on unrelated business income will apply to reserves in excess of permitted levels for VEBAs and other tax-exempt funds, except for those maintained by tax-exempt employers. Neither funds set aside for post-retirement medical benefits nor those for recreational facilities (excluding day care) are included in permissible reserves in calculating this unrelated business income tax. After a transition period, this change will mean that VEBAs and similar welfare benefit funding vehicles will be treated as taxable trusts, to the extent that they exceed the reserve limits. Welfare plans that are otherwise subject to the new legislation but are not funded through tax-exempt trusts are subject to similar rules.

Under an exception to the new rule, multi-employer welfare funds to which no employer makes more than 10 percent of the contribution are not subject to tax deduction limits. However, the exception does not apply if the employer's contributions to the welfare fund are experience-rated.

The legislation also includes nondiscrimination standards for such tax-exempt organizations as VEBAs. Also, for the first time, integration of disability benefits outside pension plans will be linked to the degree of integration within the qualified pension plan. In addition, the conference report sets forth some new restrictions on integrating disability benefits provided through a VEBA with Social Security benefits. This will apply primarily to long-term disability benefits. The report language limits the extent to which employers can "take credit" for Social Security disability payments, but it is unclear to what extent this limit will apply. These new integration limits apply only to VEBAs. Insured and unfunded long-term disability plans do not appear to be affected.