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TPF&C UPDATE

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Tax Reform '86

September 1986

FINAL TAX REFORM BILL HOLDS A FEW SURPRISES FOR EMPLOYERS

Congress is expected to vote on a tax reform bill by September 30 and the President is expected to sign it immediately. Our analysis of the just released 900-page statute and the 800-page Conference Committee report shows that, in general, the conferees followed their previously issued summary of the bill's final provisions. But among the changes we have discovered thus far are these:

- **Executive compensation**. Despite rumors to the contrary, there appears to be nothing in the transitional rules that prohibits the deferral of income from 1986 or 1987 to 1988. However, the IRS position on this matter may remain an issue for employers and executives.
- **Qualified plans**. The new participation rules, generally effective for plan years beginning after 1988, have been clarified. Separate lines of business may be taken into account in meeting each of the rules, if a reasonable classification test is met.
- The effective date of the new $200,000 limit on compensation taken into account under a qualified plan has been deferred to apply to benefits accruing in years beginning after 1988 (later for certain collectively bargained agreements).
- The integration rules have been revised and rewritten to make it more difficult to use integration (details below).
- The bill appears to limit tax-exempt organizations' use of voluntary unfunded deferred compensation arrangements (other than section 403(b) plans and section 457 plans).
- **Welfare plan** nondiscrimination rules have finally been clarified (details below).

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- Contrary to rumors, the effective date of the limitation on deductions for interest paid on policyholder loans under corporate-owned life insurance still applies to policies purchased after June 20, 1986.

New Social Security Integration Rules

In general, for an excess plan, benefits below the plan's integration level must equal at least 50% of benefits above the integration level. Similarly, for an offset plan, the offset may not reduce the benefit otherwise payable by more than 50%. In addition:

-- For an excess plan, the percentage of benefit above the integration level cannot exceed 3/4 of a percentage point times the employee's years of service up to 35 (i.e., maximum spread is 26.25%). Furthermore, the 3/4% will be reduced by future IRS regulations if the integration level is above covered compensation (currently $15,600 for those attaining age 65 in 1987).

-- For an offset plan, the amount of offset for total benefits is limited to 3/4% of the participant's final average compensation times years of service (up to 35). In calculating final average compensation, earnings above the social security wage base are ignored. However, if final average compensation, as calculated above, exceeds covered compensation, the 3/4% factor will be reduced by IRS regulation.

These changes are effective for plan years beginning on or after January 1, 1989, with delayed effective dates for certain collectively bargained plans. Early planning by employers will be required in order to meet the new requirements.

New Welfare Plan Nondiscrimination Tests

New nondiscrimination tests apply to group-term life and accident or health plans. If a plan fails these new tests, "highly compensated participants" (the same group as for qualified plans) will be taxable only on the discriminatory portion of employer-provided coverage. Employers may elect to apply the new tests to certain other welfare benefits, i.e., dependent care, educational assistance and group legal benefits, instead of current law rules.

In general, the new eligibility test requires that:

-- at least 50% of employees eligible to participate in the plan must be non-highly compensated,

-- at least 90% of the employer's non-highly compensated employees must be eligible for a benefit that is at least 50% as valuable as the

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highest value benefit available to a highly compensated employee under all plans of the same type (e.g., all accident or health plans), and

-- the plan must not contain any eligibility provision that, by its terms or otherwise, discriminates in favor of highly compensated employees.

The benefits test requires that the average employer-provided benefit received by non-highly compensated employees under all plans of the same type must be at least 75% of the average employer-provided benefit received by highly compensated employees.

Employers will be able to aggregate dissimilar welfare plans to satisfy the benefit test; combining, for example, group-term life and educational assistance plans. Accident or health plans must satisfy the benefit test on their own, but once they have done so, they can be used to help non-health plans meet the 75% rule.

Employers may also opt for a special alternative test in lieu of the eligibility and benefit tests. Under the alternative test, a plan must cover at least 80% of an employer's non-highly compensated employees. A plan meeting this standard will be deemed to satisfy both the new eligibility and benefit tests.

Cafeteria plans will still be subject to a general eligibility nondiscrimination rule. However, cafeteria plan benefits will no longer be subject to additional nondiscrimination testing. Thus, if the welfare plans offered through a cafeteria plan (such as a group-term life or a health plan) pass the new tests described above, no additional benefit tests will be applied under the cafeteria plan rules, as is the case under current law (i.e., current IRC § 125(g)(2) is repealed).

Finally, as anticipated, the welfare plan nondiscrimination rules will not become effective for plan years beginning before January 1, 1988 at the earliest.

Keeping Informed

Undoubtedly, further review of the bill will add new insights and some confusion. Nevertheless, it is likely that Congress will pass this bill and leave many of the details to the regulators.

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