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Pension Simplification: Defined-Contribution Plans

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Summary: This panel discusses the major effects of the Small Business Job Protection Act (SBJPA) of 1996 on defined-contribution plans emphasizing:

- *changes to the average deferred percentage test,*
- *corrective refunds, and*
- *401(k) and 401(m) safe harbors.*

Ms. Catherine L. Cole: I'm with Towers Perrin in the San Francisco office. Joining me is Paul Shultz, an attorney with Sutherland, Asbill & Brennan. Paul works in both the Washington and New York offices.

As all of you know, this session is about pension simplification as it relates to defined-contribution programs. While we're all actuaries and typically work in the defined-benefit area, it is becoming more important that actuaries also know about defined-contribution plans so that we can work with our clients on all aspects of their total retirement programs.

For our agenda I will talk about nondiscrimination and plan distribution rules. Then Paul will talk about Section 415, new compliance issues, plan changes and how they affect governmental and tax-exempts. He will finish by discussing those areas that relate to both individual and small-employer plans.

There are a couple different topics in the nondiscrimination section. There has been a change in the definition of *highly compensated*. We will talk about the new

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safe harbor plan that a company can adopt that would avoid most of the nondiscrimination testing. We will also talk about participation in defined-contribution plans before age 21.

Highly compensated. The definition of the highly compensated employee (HCE) has definitely been simplified and narrowed down to really two items: (1) a 5% owner in either the current or a prior year, or (2) salary in excess of $80,000 in 1997. A company can also elect to put the top 20% of paid employees in the highly compensated category. For example, in a professional service organization, if the highly compensated are limited to the top 20% of paid employees, HCE compensation may be a higher pay limit. The employer must actually make this election. The $80,000 will be indexed annually. The really positive aspect is that highly compensated individuals can now be determined at the beginning of the year based on compensation in the prior year rather than at the end of the year as under the current rules. This look-back option should solve much of the administration problem related to making refunds after the close of the year.

Another area that has been simplified is the elimination of an officer as a separate category. The Officer designation was clearly a difficult definition to administer before these changes, and this change will, for the most part, decrease the number of HCEs in most plans. However, if a company uses the 20% rule, it might not. It is very likely that the average contributing percentage (ACP)/average deferred percentage (ADP) tests will be easier to pass as a result of this change. This is because the employees who make between $66,000 and $80,000 are likely to contribute more to a plan now that they are considered nonhighly compensated and that will raise the non-highly compensated employee (NHCE) percentage and allow the HCEs to, in fact, contribute more. This will take some communication because some of these employees who have otherwise been limited now need to be encouraged to raise their contributions to higher percentages. The effective date for this definition is, essentially, years after 1996.

From the Floor: Will somebody making $70,000 in 1996 be an HCE or an NHCE in 1997 testing?

Ms. Cole: The person will be a NHCE in 1997 testing.

From the Floor: So the person is a HCE in the 1996 test and an NHCE in 1997, based on the same compensation.

Ms. Cole: That's correct.

One plan design that was long sought after by most corporations was a safe harbor plan. That is, if the plan met all the conditions, the plan would avoid all nondiscrimination testing. I doubt that the plan defined in the pension simplification regulations is what employers were wanting, but nonetheless we now have a safe harbor defined-contribution plan in the regulations. When you look at what's involved to meet these new regulations, you'll see why many employers are not thinking about putting in this plan. It's especially true in the case where the employer has both a defined-benefit and a defined-contribution plan. In organizations where there is only a defined-contribution plan, and the employer makes a reasonable contribution, there is value in reviewing this safe harbor plan.

What is the new safe harbor plan? There are two components. There is the ADP testing, which is the testing of the salary deferrals that employees elect to have deferred from their pay. The second component is the ACP, which is the testing of the employer-matching contributions and any employee after-tax contributions.

The ADP test under the safe harbor plan is met if the employer's contribution on those salary deferrals is a 100% match on the first 3% of the employee contributions plus an additional 50% match on the next 2%. Another way to satisfy the safe harbor would be to have a 3% nonelective contribution. A nonelective contribution is one that does not require the employee to make any contributions to get an employer contribution. It also says in the law that this 3% does not have to go into the 401(k) plan. It can be counted as a safe harbor contribution if made as a 401(a) contribution to some other type of program. However, contributions to cash balance plans cannot be deemed to satisfy this 3% rule. Also, as of my last reading, and there may be more current information, the actual definition of compensation that has to be used for this wasn't clear. The expectations are that these percentages will have to be based on the same pay that applies to employee deferrals.

There is a reference to an alternative plan. An alternative plan doesn't have to be exactly one of the top two that were mentioned earlier, the 100% and the 3% safe harbors. An alternative could be a 100% match on 4% of employee contributions, but the new rules would not allow an 80% match on five. What's not deemed to be an equivalent of the safe harbor is the 100% on three and the 50% on two. There are some other restrictions that need to be considered. The employer contribution is 100% vested, which is certainly more generous than many plans today. It is OK to only vest new contributions after adopting the safe harbor plan design so a plan could keep graded vesting on prior contributions. This could complicate the administration, but it is certainly doable. A further restriction is that a plan cannot provide for hardship withdrawals on the employer contributions. Hardship withdrawals on employee contributions are allowed.

Most companies will find the restrictions onerous and will not consider changing their current plans to the safe harbor plan just to avoid the nondiscrimination testing. As I mentioned earlier, those companies that have defined-contribution-only plans, and are already making contributions somewhere in the neighborhood of the safe harbor requirements, may be interested in restructuring.

Mr. Paul T. Shultz: This came primarily from the employer community because everybody said we really ought to have a safe harbor. We should be relieved of the burden of doing this testing. It will be interesting if nobody goes to the safe harbors and they all simply stay with the current testing. I suppose it might attract some people to form new 401(k)s where they might not have in the past.

Ms. Cole: I agree. We could also have more companies go from a defined-benefit to a defined-contribution, too.

Mr. Schultz: True. We might ask if anyone in the audience has any experience or views on it. I'd be really curious to see if anybody has seen companies start to seriously consider it even though it's kind of early.

Ms. Cole: Was there any excitement by employers in general about this?

From the Floor: Yes, from smaller plans.

Ms. Cole: Smaller employers that have had greater difficulty meeting these tests in the past should look at it very seriously. Even if it raises their contributions, I think they'll want to do so to allow greater contributions by the highly compensated.

There are a few other requirements under this safe harbor. There has to be an annual notice of the rights and obligations to all participants and to all nonparticipants. The overall rate of employer contributions to the highly compensated cannot exceed the rate to the nonhighly compensated. As sort of a side point, although I think it's somewhat obvious, you cannot have a plan that matches 100% on the first 3% of employee contributions and 150% on the next two. The percentages cannot increase on contributions in excess of 3% and still stay within the safe harbor plan.

Mr. Shultz: Let me also comment. I found it startling that they would put into the tax code a requirement of a notice of rights and obligations each year. It's almost as if Congress is saying that it doesn't really believe that the Labor Department's required disclosure, the summary plan descriptions, for example, and other related

disclosure material, really works or really is effective in that it adds another tax-related requirement as well.

Ms. Cole: It may be because there is no requirement to annually update the summary plan description (SPD). Perhaps there's some reason for it.

Under the safe harbor plan, the ACP testing can be avoided as long as the matching on the compensation does not exceed 6%. There is one wrinkle and that has to do with after-tax employee contributions. Many plans in the corporate world have both matching contributions on pretax and after-tax employee contributions. The match on the after-tax portion does not avoid testing under a safe harbor plan. So, if you have to put the after-tax contribution back in and test it, you still may have some testing problems. This might be another compelling reason to eliminate after-tax contributions altogether, at least those made by the highly compensated.

Mr. Shultz: Do you have any insight as to what the policy reason was for continuing to keep the after-tax employee contribution subject to the ACP test?

Ms. Cole: The only issue that I am aware of is that it has always been assumed that only the highly compensated people can afford to make after-tax contributions.

From the Floor: I would guess because you have the $9,500 limitation on the highly compensated that they are the ones who get tapped at $9,500.

Mr. Ethan E. Kra: The question is, why do they even have to bother with ACP testing if it's not being matched if these excessive contributions are being made by HCEs? I think what most people, especially those in Congress on the Hill, are missing out on is that a person putting in a substantial amount of money (i.e., somebody who will meet the insurance company's minimum premium thresholds), can match the tax treatment of after-tax contributions by buying a nonqualified deferred annuity product. A 403(c) annuity product, in fact, gets better tax treatment because the investment earnings are not subject to an excess distribution tax for an excess accumulation tax, and there's more flexibility. There's no 401(a)(9) required distributions.

Mr. Shultz: That's something to explore. I don't think people have generally used that, and I don't think they're generally familiar with it. There must be some negative or downside to 403(c)s.

Ms. Cole: One of the implications of not having to do the ACP testing is that you don't have to do the 401(k) testing on the matching portion of that contribution. Typically, this will eliminate much of the testing and expense burden. The safe

harbor plan is for years beginning after 1998. The purpose of the delay is to give companies time to analyze it, compare the cost, and see if it'll work for them.

Participation simplification. This is separate from the safe harbor. Currently, employers have to test all employees who are eligible for the plan. Under the new legislation, eligible participants who are less than 21 or who have less than one year of service can be partitioned and tested separately. A number of companies have immediate participation in 401(k) plans. This accommodates those new employees who have come over from another employer who were making contributions and want to continue making contributions once they're employed someplace else. Generally, it is easier to satisfy the testing on the under-21-and-one group than to separately satisfy the testing on the 21-and-one group. If you then fail the testing in that category, you would be refunding to a smaller group of employees. However, they do still have to be tested under 410(b). The coverage rules still have to be applied.

From the Floor: Basically, the 21-and-one group is tested separately, but we might have had a refund.

Ms. Cole: That's correct.

From the Floor: We can now test these under-one-year-of-service HCEs with the rest of the HCEs.

Ms. Cole: It makes it much nicer. What are the implications? I think they're somewhat obvious. Because the under-21-and-one group typically has lower contribution rates, we now will not be lowering the contribution rate for the highly compensated, at least on behalf of those individuals, and we'll no longer have to exclude the new hires. This is effective for years beginning after 1998—I guess I was a little surprised this one didn't have a faster implementation date. It doesn't really require a whole lot of extra work to make this test because most employers are actually having to do it separately now anyway.

Look-back testing. Look-back testing dramatically simplifies what is now a fairly complex process for employers. Currently, an employer looks at the end of the year to determine what happened during the past year. What were the HCEs contributing? What were the NHCEs contributing? Did the plan pass or fail? If it failed, did the plan do cutbacks or refunds? Now the employer can identify the circumstances at the beginning of the year and know whether to cut back in advance. So you look at last year's ADP by the NHCEs. That's a little tricky because it is the percentage for current-year NHCEs. What was their ADP last year? You will have the current group of NHCEs, but it won't be the same percentage as it

was last year; nevertheless, it's still easy to do. You know who they are at the beginning of the year. You know what they deferred last year. You get a new average percentage, and then you can also look at your HCEs.

From the Floor: I think many of us thought that was the prior year's ADP for last year's NHCEs because the question came up about what to do in the first year that this applies. Do we have to redefine who the HCEs were last year? I think what we got from the IRS during the gray book discussions was that for 1997 we would take the 1996 test results, assuming we were not using a look-back, and we use the current- year election. We would take the actual 1996 test results not redefine the $80,000 instead of the lower limit and use that number for 1997.

Ms. Cole: That's not my understanding, but I welcome other input.

Mr. Shultz: I had this similar kind of reaction when I heard you say it a minute ago. I didn't pick it up before, but I have the same recollection as the speaker. I had a conversation a couple weeks ago with a number of the people at the Service. They were worried about major changes in testing, and whether the group has changed so significantly that they would have to go back and look at this year's as opposed to last year's. I think that's right, but I'm fuzzy on it.

Ms. Cole: I'll read you what I understood from an interim memorandum. This means after the close of a year, an employer must both identify the new group of HCEs and NHCEs for the current year and then retrieve the prior contribution rates for those identified as NHCEs for use in the current-year ADP and ACP tests.

Mr. Shultz: When was that dated?

Ms. Cole: End of last year.

Mr. Shultz: I think there has been some progress in that.

Ms. Cole: I haven't heard that changed, but I apologize if that is the case.

Let's scratch what I said for the last few minutes, and we'll clarify that you'll actually use last year's ADP test results. You'll use those as the beginning-of-the- year tests to determine what the highly compensated can contribute this year. The highly compensated are the employees who are redefined at the beginning of this year.

Family aggregation. One of the other items that was simplified was the repeal of the family aggregation regulations. Again, a good thing, but it doesn't affect many employees in organizations. Large companies could have an HCE who has a

spouse or child working, and there could be problems on the ability to contribute. Now all of those individuals will be treated as separate people. There will be no family aggregation, and that is effective in 1996.

Disabled employees. Prior to this law, disabled employees really didn't have any compensation on which to make contributions, but now highly compensated disabled employees can defer from their disability income. It could cause some administrative issues, but it can certainly be done. This is effective in 1997.

Plan distributions. I'm going to cover four topics here: the suspension of the 15% excise tax, the repeal of the five-year income averaging, the joint-and-survivor (J & S) rules, and the required beginning date for the age 70½ rule. Something I'm sure we're all very well aware of, whether you work in a defined-benefit or defined-contribution area, is the fact that the 15% excise tax has been suspended for 1997, 1998, and 1999. However, that has not affected estate excise taxes.

Mr. Shultz: I'd like to make a couple of comments. I think there's a good chance that it might be extended because this is a revenue-raiser, and Congress probably will have some incentive to extend it just so it can keep raising this revenue. Even though it's nice to be able to pull out your money without subjecting it to a 15% excise tax, in fact, based on most projections, it's probably more advantageous to leave it in, even assuming you're going to pay that 15% excise tax in the future, but you have to make very careful, specific projections.

From the Floor: It was also tied into the repeal of 415(e).

Ms. Cole: Yes.

From the Floor: I think there'll be tremendous lobbying not to extend the effective date.

Mr. Shultz: I would agree with that, but I guess that it might get decoupled.

From the Floor: The reason that these issues were coupled is that, originally, they were supposed to repeal 415(e) at the same time because once you have this excise tax, 415(e) is irrelevant.

Ms. Cole: One of the downsides of this new legislation affecting defined-contribution plans is the repeal of five-year income averaging. It is gone after 1999, which affects most employers from a communications standpoint. Again, if somebody's going to be retiring in the next couple years, this is something the person should be aware of. Most of the employers are putting together some form

of communication to let people know that they may want to get to a tax advisor and make sure that they're doing all the right things between now and 1999.

Qualified J&S rules don't typically impact defined-contribution plans. Under the legislation the 30-day notice is now waived. This is important—the Treasury has been directed to develop a J&S consent for the qualified domestic relations order (QDRO) side.

Mr. Shultz: Both spousal consent and QDROs, and they've come out with both of them.

Ms. Cole: This next issue is about distributions after age 70½. I know many employers jumped to the conclusion that they could suddenly stop paying all their employees who are getting age 70½ distributions, and they didn't have to continue them into the future, but we still have the 411(d)(6) issues for cutbacks. Most of the employers I work with on defined-benefit plans are doing business as usual on the age 70½ rule, and I think we're seeing the same thing on defined-contribution plans. However, the plan can permit participants who are currently receiving these distributions to stop them if they want to, as long as they get the permission from the employee.

Mr. Shultz: If I may just add a footnote, my conversations with people at the Treasury indicate that there's a substantial likelihood that they're going to say 411(d)(6) does not allow an employer to remove the ability of an employee to begin benefits at age 70½ while actively employed.

Mr. Kra: Will they give it just to a grandfathered group or make it for all accrued benefits? There was talk that they would give 411(d)(6) relief to people who were not age 65 by January 1, 1997.

Mr. Shultz: I didn't get that far into the details.

Ms. Cole: I heard the same thing that you did, Ethan, which is that they may have some grandfathered group, but Treasury didn't like it. It wasn't clean enough in their minds, so there seems to be some backpedaling on that possibility. I think most employers are doing business as usual as it relates to age 70½ because they're not very sure about what they can or can't do in the future.

I'm going to turn it over to Paul who will take on some of the other sections.

Mr. Shultz: I'm going to cover four more broad topics. The first is the 415 rules. Second, we will talk a little bit about the definition of a 415 company and, third, the

repeal of the 415(e), which we have talked a little bit about. The definition of compensation was broadened by SBJPA. Deferrals under 175, 401(K), 403(B), and deferred compensation under 457 were excluded from compensation under the 415 definition. This meant that people could not include those deferrals as part of their compensation for purposes of the 415 limits, for both the limit and for deduction purposes as well. The addition of these other deferrals causes you have a larger base, and this increases the permissible contributions and benefit amounts that can be provided. It particularly helps lower-paid employees who are covered under 401(k) plans, which is one of the sources of the problems we've had in the past. In general, the compensation definition now will be identical to that used for determining the HCEs. This becomes effective for plan years beginning in 1998.

The other change affecting 415 is the repeal of 415(e), which we talked about and which is scheduled to take effect in 1999 and be coupled with the premium holiday and the 15% excise tax. We're hoping that won't happen—that whatever its fate, it won't affect the repeal of 415(e) because this is something that's been sought for many years. This is expected to ease that part of the administration of defined-contribution plans, and it will eliminate the need to keep all these historical data and actually result in the increase in benefits for some people from qualified defined-benefit plans, perhaps decreasing benefits under nonqualified plans, such as your nonqualified supplemental executive retirement plans (SERPs) which is effective in 1999.

Let's move next to the fourth area the compliance items. Here we will cover the Veterans' Reemployment Rights issues, the timing of amendments required to comply with the changes made by SBJPA and, finally, the minimum participation rules. For many years the issues related to returning veterans and their benefits have been moving around in legislation and in courts. The court case *Alabama Power*—about ten years ago—held that defined-contribution plan benefits must be provided to rehired people who'd been in the service. Then in 1994 Congress acted by adding 414(u) to the code, but there were many questions as to how it applied, and the technical issues were finally addressed by the SBJPA. That law provided that rehired veterans can make up their contributions and essentially be treated the same way they would have been treated if they continued to be employed. A number of different rules put this into effect. For example, the employee has to be treated as having received the same salary while he or she was in the service as he or she would have received if he or she had been employed. If you can't determine what that is, then look at the salary he or she earned during the 12 months before leaving. The person has to be allowed to make up 401(k) deferrals, has to be allowed to make up after-tax contributions, and has to have the employer make up any employer contributions that would have been made. Contributions that go in are subject to the 402(g) limits at the time they go in, but

they're not treated as subject to the nondiscrimination rules at the time that they go in. A loan suspension while in the military service doesn't count against the five-year loan repayment limit. The statute actually requires compliance by October 13, 1996, which is the effective date of the enactment date of SBJPA, but another pronouncement was issued by the Service that delays the timing of the amendments to comply with this law for the required amendment timing.

In SBJPA, Congress provided that the pension simplification amendments are not required to be made before the first plan year beginning on or after January 1, 1998; in other words, they should begin in 1998, or later, depending on when the plan year begins. Actually there's a little bit of an issue here as to when you really need to have this amendment made. You may recall that if you have an amendment that's required to be made to a plan to keep it qualified, then 401(b) provides what's called a remedial amendment period. The regulations under 401(b) provide a remedial amendment period, which says basically that you have until the time for filing the tax return for the year for which you have to comply to make the amendment and have it in effect. With respect to SBJPA, most of the amendments that are required are, in fact, optional. I think only a couple are actually required. For example, the multiemployer plans have to go to five-year vesting. But by and large, they're optional amendments, and because they're optional, I think many of us have concluded, therefore, that they have to be made by the end of the actual year to which they apply. For a calendar-year plan, the amendment would have to be made by December 31, 1998, not in time for filing your tax return for 1998, as would be the rule if you were relying on 401(b).

It's commonly interpreted to mean that it has to be effective as of the first day of that plan year, and it can be amended at any time during that year retroactively to the beginning of the year. It does say that, and I've always found it to be a strange and surprising statement in view of the way practice operates. I suppose some people will come along and say, “You can't really make it retroactive because you haven't operated your plan. It hasn't been in effect.” Your legal rights are affected. But I know and you know that generally the way people do operate is by having it done by the end of the year.

Next, the last compliance item I want to discuss is that the minimum participation requirement of 401(a)(26), the “50 employees or 40% of all employees of the employer,” no longer applies with respect to defined-contribution plans. That has been eliminated. It's also been eliminated for separate lines of business. What are the implications? This, in fact, may remove an obstacle for some employers to the establishment of small defined-contribution plans, and we may see more of those developing, effective in 1997. Trivia question for the week. Can anybody tell me what impact this has on determination letter filings? This is just something I

happened to run across the other day. I discovered an IRS notice that actually tells us that we don't have to file Schedule Q to Form 5300 any further with respect to an application for a determination letter for a defined-contribution plan because of this change. I thought I would share that important piece of information with you.

Let's move to governments and tax-exempts, and here changes are made in several areas affecting 403(b) plans, affecting 457 plans, affecting tax-exempt employers and their ability to have 401(k) plans. The 403(b) plans experienced several changes. First, it is now possible to have more than one deferral per year. You know that in a 401(k) plan you can make an election, and you can change that election as often as the plan allows. In 403(b)s you were previously allowed to make a salary reduction or a deferral agreement only once in a year, and now the statute has been changed to make it clear that you can have more than one in a year, putting them on a footing comparable to 401(k). That was effective immediately and is actually effective for all of 1996.

Ms. Cole: Let me ask a quick question on 403(b) plans as it relates to the definition of compensation. If I read things correctly, within 403(b) there are a couple different limits. One is 415. One is the general limit of essentially $9,500, and one is the maximum exclusion allowance. Obviously, the compensation on 415 has changed. You can now add it back in your 403(b) contribution, but what I'm hearing is that for the calculation of the maximum exclusion allowance that you cannot add back in a 403(b) contribution in that compensation definition. Do you agree with that?

From the Floor: Yes.

Mr. Shultz: I don't do these very often, but my recollection is that the exclusion allowance is created on a retrospective basis for the entire career of the individual. If you applied this provision, from a full-career retrospective impact, it would be a huge increase in the amount available to put in.

Ms. Cole: Effectively, it's usually 20% times current salary, current salary doesn't have 403(b) in it.

Mr. Shultz: But if you go back and add all the 403(b) contributions you've ever made, your historical current salary is significant. Well, it could be up to 20% larger, I suppose.

Moving to 457 plans, a number of things happened here. First, the $7,500 limit, which is different from the $9,500 limit under 402(g), was changed to be indexed in $500 increments. My recollection is that the $9,500 limit under 403(b) was also

changed, and the indexing was added to that, so in fact, it became the 402(g) limit. But the 457 limit of $7,500 is now indexed, and I think the indexing takes effect this year, and at that point it will be, again, more like 401(k), but not just like it. Also, a provision was added to 457 that allows in-service distributions of small amounts using the $3,500 amount that is applicable under qualified plans. For 457 plans the implications are that there will be increased distribution options. These changes are both effective for years after 1996.

Finally, for tax-exempts it is possible now to establish a 401(k) plan, which has not been true up until now. Of course, you'll recall that only some tax-exempts can establish 403(b) plans. They can now establish 401(k)s. Tax-exempts that can have a 403(b) and a 401(k) are now trying to decide whether they go with a 401(k) or a 403(b) or both. My conversations have indicated that many of them think that there's more play in a 403(b), and they're less attracted to a 401(k). However, the other tax-exempts, the ones that can't have 403(b)s, are very pleased to be able to contemplate having 401(k)s now and I suspect will be establishing them as they can. Do you have any experience on that, Catherine?

Ms. Cole: We did an informal survey perhaps a month or so ago. Somebody wanted to know what tax-exempts were going to do, 403(b) versus 401(k), and it was overwhelming that those who had 403(b)s were probably going to stay with them because of the onerous testing on 401(k) programs that they don't have on 403(b).

Mr. Shultz: Note that this extension of 401(k) is only to tax-exempts; it does not include governments. Governments continue not to be able to maintain 401(k) plans. Note also in the statute that there was a provision that allowed Indian tribes that happened to establish 401(k) plans before 1995 to continue to maintain them, but it is only this grandfathered group of Indian tribes. Some people had thought that this was a broader provision, but that's not the case. It has to be thought about in that limited way. Implications, again, increased options for various tax-exempt organizations beyond 457 and 403(b), effective 1997.

Let's move now to individual and small-employer incentives. First, we'll talk a little bit about the Savings Incentive Match Plan for Employees (SIMPLE), then about an employee stock ownership plan (ESOP) change, and then about an IRA change. I don't know how much interest there would be by the people here in SIMPLEs, but it is an interesting development that we probably want to keep our eyes on because you never know where these are going to go. It's a successor to some of the earlier efforts, starting with IRAs and then moving on to self-employed pension plans (SEPPs), and this is the latest iteration of it. You can set it up in the form of an IRA or a 401(k) plan. Some very specific requirements apply to the establishment of

one. You have to provide 100% vesting of contributions that are at least 2% of pay on a nonelective basis or a 100% match on the first 3% of deferrals if you have a 401(k). Then there's something about contributing less than that in a two out of five-year period. It really sounds simple, doesn't it? All employees must be eligible. It's available only to employers with 100 or fewer employees, and the deferral amount is limited to $6,000. It's effective in 1997. I believe people are starting to set them up but, again, it's probably not a market that many of you are close to.

In the ESOP area, long a target of legislation, mostly to provide incentives for ESOPs, there was a little bit of a cutback. At this point, the 50% interest exclusion for loans to ESOPs has been repealed effective with the date of passage of the act. That's not 1995, but 1996, actually. This was available only for ESOPs that owned more than 50% of the employer organization. The repeal likely will not slow things down too much in terms of enthusiasm for ESOPs because there is a lot of enthusiasm. Another interesting point is, effective 1999, Subchapter S corporations will be allowed to sponsor ESOPs. This hadn't been true previously and is not something that can be done right at the moment, but no doubt some Subchapter S corporations will move in that direction.

Finally, spousal IRAs. To the extent that anyone is covered under a qualified plan, we still experience the phaseout of the deduction. This might not be that important, but to the extent that one is not otherwise covered under a qualified plan or that the income phaseout provisions don't apply, we've moved from a maximum deductible contribution for a spouse of $250 under prior law to a $2,000 limit (under this change, which is effective in 1997). Of course, the parties have to file a joint return to take advantage of this, and that's a potentially helpful provision.

From the Floor: Now, if one spouse has a qualified pension plan, does that change it for the other?

Mr. Shultz; Yes, it does.

Ms. Cole: So then who would this help?

Mr. Shultz: That's what I'm trying to figure out.

From the Floor: Perhaps people who switched jobs during the year.

Mr. Shultz: That's true. I, in fact, changed jobs last year, and I had a one-year period during which I was not covered under a qualified pension plan, and after I successfully argued with my former employer that I wasn't covered last year, I was able to make my IRA contribution for last year.

I think we're at the point where we could open it up and see what else we'd like to talk about.

From the Floor: If you're in a plan year that's a July 1 plan year, and you quit December 31, and you accrue a benefit during that period, you're considered to be a participant in that plan in the next tax year, even though you're not an employee of that employer.

Mr. Shultz: What is the date?

From the Floor: The plan year is July 1, 1995 to June 30, 1996. You quit December 31, 1995. It's a 401(k) plan with no match; just your money is going in.

Mr. Shultz: Because of the overlapping year, you're deemed to be a participant in that plan in 1996, even though you're not an employee and you put nothing in during 1996.

Ms. Cole: But you didn't get a W–2 from that prior employer.

From the Floor: It may be difficult for the IRS to catch you because the employer would have to give you a W–2 with no income but with the box checked. Everything was paid by the end of the year. They even paid out the benefits from the plan. You still cannot have a deductible IRA that next year.

Ms. Cole: I would like a show of hands. Are there employers out there that are looking at the safe harbor plan design on the defined-contribution side as a way to avoid testing?

From the Floor: I think it's too early to know.

Ms. Cole: You've got some? OK.

From the Floor: I think it depends on whether they're already doing the match at that level.

Ms. Cole: I agree. About the only reason an employer would be interested is because the company is already making similar contributions. It is fairly common in the U.S. for defined-contribution plans, especially where a defined-benefit plan exists, to match 50% on 6% of pay. That's a big increase if you go to 100% on three and then 50% on the next two. Costwise, I think it's not going to happen very often.

From the Floor: I think the hardship feature will be difficult. It's telling the low paid that for us to do something better for the high paid you can't get hardship withdrawals.

Mr. Shultz: That's a good point, and it's one of the reasons I think people have been so willing to put money into a 401(k)—because they knew that there was that safety valve to get that money out for an important purpose.

Ms. Cole: I think that's why you still see a lot of after-tax contributions being made by low-paid individuals. They can get their money out as they can from a checking account faster than they can get it the other way. Some employers are reluctant to do away with after-tax for the nonhighly compensated because of that feature. They would then not participate.