February 23, 2006

<u>Via Facsimile (202) 622-0236</u>

Mr. Tom Reeder
Acting Benefits Tax Counsel
Department of the Treasury
1500 Pennsylvania Avenue NW
Washington, DC 20220

Re: Vesting Rule in Final 401(k) Regulations

Dear Tom:

The undersigned hereby respectfully request that the Treasury Department change one part of the final regulations under Internal Revenue Code section 401(k). The regulation that we request be changed is Regulation section 1.40(k)-1(c)(1). Specifically, we request that the "(2)" be eliminated after "section 411(a)" in the first (and only) sentence of Regulation section.401k-1(c)(1). The reasons for our request are provided below.

<u>Background</u>. Internal Revenue Code section 401(k) contains requirements applicable to cash or deferred arrangements. The only vesting rule in Code section 401(k) is Code section 401(k)(2)(C), which requires that an employee's right to his accrued benefit derived from employer contributions made to the plan's trust pursuant to the employee's election be nonforfeitable.

Prior to December 29, 2004, final regulations issued under Code section 401(k) (that were issued in final form in 1994) provided the following regarding Code section 401(k)(2)(C):

> *General rule* – A cash or deferred arrangement satisfies this paragraph (c) only if the elective contributions meet each of the following requirements: . . . (ii) The contributions are disregarded for purposes of applying Section 411(a) to other contributions or benefits.

See prior Regulation section 1.401(k)-1(c). Note that there was no "(2)" after "411(a)."

On July 17, 2003, proposed regulations were issued under Code section 401(k) to replace the existing 1994 final regulations. The proposed regulations made changes needed due to statutory changes made since the existing final regulations were issued in 1994. Concerning

Code section 401(k)(2)(C), similar to the existing final regulations, the proposed regulations provided (in section 1.401(k)-1(c)(1)) the following:

> (c) *Nonforfeitability requirements* – (1) *General rule.* A cash or deferred arrangement satisfies this paragraph (c) only if the amount attributable to an employee's elective contributions are immediately nonforfeitable, within the meaning of paragraph (c)(2) of this section, are disregarded for purposes of applying section 411(a) to other contributions or benefits, and the contributions remain nonforfeitable even if the employee makes no additional elective contributions under a cash or deferred arrangement.

Without any advance notice that would have given plan sponsors and other interested parties the opportunity to comment, the final regulations that were issued on December 29, 2004 (i.e. Regulation section 1.401(k)-1(c)(1)) changed the existing regulations concerning Code section 401(k)(2)(C) by adding the "(2)" after "section 411(a)." The preamble to the final regulations describes the reason for the change as follows:

> The final regulations reflect the statutory requirement that elective contributions to a qualified CODA be immediately nonforfeitable. However, the final regulations clarify that the reference to these contributions being "disregarded for purposes of applying section 411(a) to other contributions" is limited to being disregarded for purposes of section 411(a)(2). Thus, for example, elective contributions under a qualified CODA are taken into account for purposes of determining whether a participant is a nonvested participant for purposes of section 411(a)(6)(D)(iii).

The change, which we believe is not justified under the law, necessitates counting <u>all</u> years of service for an *indefinite* period of time with respect to any terminated employee who made elective deferral contributions to a plan but did not vest in employer matching contributions or profit sharing contributions. Such a recordkeeping requirement can be substantial. It should be required only if the law mandates it. For the following reasons, we believe that the law does not mandate such a requirement.

<u>The Code and the Legislative History</u>. As mentioned above, the only vesting rule in Code section 401(k) is section 401(k)(2)(C). That rule simply requires that elective deferral contributions be fully vested at all times. It requires nothing more.

Code section 411(a)(2) relates to vesting of accrued benefits "derived from employer contributions." The pertinent substantive issue is whether an elective deferral contribution under Code section 401(k) is an accrued benefit derived from employer contributions for purposes of the vesting provisions of Code section 411(a). The legislative history of Code section 411(a) and the Employee Retirement Income Security Act of 1974 (ERISA), section 2006 of ERISA and the language of Code section 411(a) evidence that elective deferral contributions under Code section 401(k) are not accrued benefits "derived from employer contributions" for purposes of the vesting provisions of Code section 411(a).

When ERISA was enacted in 1974, Code section 401(k) did not exist. Prior to ERISA, the Treasury Department had issued three Revenue Rulings, 56-497, 63-180 and 68-89, that permitted contribution of profit-sharing amounts to a qualified plan via elective deferral. In 1972, a proposed regulation was issued that treated elective deferral contributions as employee after-tax contributions. That proposed regulation was section 1.402(a)-1(a)(1)(i). A copy is enclosed.

When ERISA was enacted, the proposed regulation (§1.402(a)-1(a)(1)(i)) was essentially codified, subject to an exception for existing deferral arrangements adopted in accordance with Revenue Rulings 56-497, 63-180 and 68-89. See enclosed ERISA Section 2006, and pertinent language from Senate Report 93-383 and House Conference Report 93-1280.

Substantively, 401(k) elective deferrals are employee contributions, because they are sourced from the employees' paychecks. In 1974, with the exception of the above-mentioned grandfathered amounts (i.e. pursuant to ERISA Section 2006), the only employee contributions that were lawfully recognized under the Code and ERISA were after-tax (thrift) contributions.

The legislative history of ERISA and the Revenue Act of 1978 evidence that the intention of the drafters of ERISA was that vesting of accrued benefits meant vesting of benefits derived from employer contributions (i.e. employer money) and not employee elective deferral contributions. See enclosed legislative history. When Code Section 401(k) was added in 1978, elective deferrals effectively became employee contributions for purposes of Code Section 411(a).

Since 1974, section 411(a)(1) has always provided that an employee is fully vested in his own contributions. Since 1974, Code section 411(a)(2) has always provided a vesting schedule that applies to employer contributions. For these purposes, elective deferrals cannot be deemed subject to Code section 411(a)(2). The provisions of Code sections 411(a)(3)-(6) relate to Code section 411(a)(2), and the "years of service" provision included therein. For example, as it did immediately following ERISA's enactment, section 411(a)(4) begins as follows: "In computing the period of service under the plan for purposes of determining the nonforfeitable percentage under paragraph (2)..." Code section 411(a)(6)(D), which is cited by the preamble to the December 29, 2004 final regulations, begins (as it began immediately after enactment of ERISA): "For purposes of paragraph (4)..." Thus, it would be unreasonable to suggest that elective deferrals are employer contributions derived from employer contributions for purposes of section 411(a)(4) and section 411(a)(6). (The entire purpose of section 411(a)(4) and section

411(a)(6) is to set forth rules to specify when vesting service credit is required. Full vesting is always required with respect to elective deferrals.) Code Section 411(c) does not impact this result, given the foregoing history. Accordingly, the applicable provision of the final regulation (i.e. the "(2)") should be disregarded as an invalid interpretation of applicable statutory law. *Cf.* Goodson-Todman Enterprises, Ltd. v. Commissioner, 84 T.C. 255 (1985).

The Procedural Change Is Unlawful. The inclusion of the "(2)" after "section 411(a)" in the final regulations, when such provision was not included in the proposed regulations or the existing regulations (and is not found in the statutory language of Code section 401(k)) may violate the law applicable to regulatory guidance. It absolutely would violate the law, if the regulation was a legislative regulation. *See* American Standard Inc. v. U.S., 220 Ct. C1. 411, 602 F.2d 256 (1979). Furthermore, because vesting is a completely different area of retirement benefits law than elective deferrals under a cash or deferred arrangement, it was inappropriate to add a vesting rule to the Code section 401(k) regulations.

The Regulation is an Interpretative Regulation that is not Law. The regulation in issue is not a legislative regulation. Rather, it is an interpretive regulation. Therefore, it is not legally binding. *See* Erringer v. Thompson, 371 F.3d 625 (9th Cir. 2004); Star Enterprise v. EPA, 235 F.3d 139 (3rd Cir. 2000) As noted in the Fourth Edition of *Administrative Law Treatise*, by Richard J. Pierce, Jr. Volume I (2002), at page 325:

> A court may choose to give binding effect to the position taken by an agency in an interpretive rule, but it is the court that provides the binding effect of law through its process of statutory interpretation; the agency's interpretative rule serves only the function of potentially persuading the court that the agency's interpretation is correct.

As held in Christensen v. Harris County, 529 U.S. 576, 120 S.Ct. 1655, 146 L.Ed.2d 621 (2000) the deference acknowledged by Chevron v. Natural Resources Defense Council, Inc., 467 U.S. 837, 104 S.Ct. 2778, 81 L.Ed.2d 694 (1984) does not apply to interpretive regulations. As noted by the Administrative Law Treatise at page 328: "The distinction between the binding effect of legislative rules and the nonbinding effect of interpretive rules is deeply embedded in Supreme Court opinions and congressional practice." Instead, an interpretative regulation merely "...provide(s) a practical guide to employers and employees as to how the office representing the public interest in its enforcement will seek to apply it." *See* Skidmore v. Swift & Co., 323 U.S. 134, at 138, 65 S.Ct. 161, 89 L.Ed. 124 (1944).

Probably most important*, while the regulation in issue is merely the Treasury Department's view of the law, as a practical matter, given the* ***tremendous potential exposure*** *if the qualification rules are not met, virtually all plan sponsors will need to "fall in line" and follow the regulation. Thus, it is up to the Treasury Department to correct this error.*

Otherwise, virtually every qualified plan in the U.S. will need to comply with a burdensome additional rule that is not justified under the law.

We look forward to a response.

Sincerely,

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Enclosures

(10) Section 122(b)(2)[88] (relating to consideration for the contract) is amended by striking out "72(o)" and inserting "72 (n)".

(11) Section 405(e)[89] (relating to capital gains treatment and limitation of tax not to apply to bonds distributed by trusts) is amended by striking out "Section 72(n) and section 402(a) (2)" and inserting "Subsections (a)(2) and (e) of section 402".

(12) Section 406(c)[90] (relating to termination of status as deemed employee, etc.) is amended by striking out "section 72 (n), section 402(a)(2)" and inserting "subsections (a)(2) and (e) of section 402".

(13) Section 407(c)[91] (relating to termination of status as deemed employee, etc.) is amended by striking out "section 72 (n), section 402(a)(2)" and inserting "subsections (a)(2) and (e) of section 402".

(14) Section 1348(b)(1)[92] (relating to earned income) is amended by striking out "72(n), 402(a)(2)" and inserting "402 (a)(2), 402(e)".

(15) Section 101(b)(2)(B)[93] is amended by striking out "total distributions payable (as defined in section 402(a)(3)) which are paid to a distributee within one taxable year of the distributee by reason of the employee's death" and inserting in lieu thereof "a lump sum distribution (as defined in section 402(e) (4))".

(d) Effective date.—The amendments made by this section shall apply only with respect to distributions or payments made after December 31, 1973, in taxable years beginning after such date.

SEC. 2006. SALARY REDUCTION REGULATIONS.

(a) Inclusion of certain contributions in income.—Except in the case of plans or arrangements in existence on June 27, 1974, a contribution made before January 1, 1977, to an employees' trust described in section 401(a), 403(a), or 405(a) of the Internal Revenue Code of 1954[94] which is exempt from tax under section 501(a)[95] of such Code, or under an arrangement which, but for the fact that it was not in existence on June 27, 1974, would be an arrangement described in subsection (b)(2) of this section, shall be treated as a contribution made by an employee if the contribution is made under an arrangement under which the contribution will be made only if the employee elects to receive a reduction in his compensation or to forego an increase in his compensation. ✓

(b) Administration in the case of certain qualified pension or profit-sharing plans, etc., in existence on June 27, 1974.—No salary reduction regulations may be issued by the Secretary of the Treasury in final form before January 1, 1977, with respect to an arrangement which was in existence on June 27, 1974, and which, on that date—

88. 26 U.S.C.A. (I.R.C.1954) § 122(b)(2).
89. 26 U.S.C.A. (I.R.C.1954) § 405(e).
90. 26 U.S.C.A. (I.R.C.1954) § 406(c).
91. 26 U.S.C.A. (I.R.C.1954) § 407(c).
92. 26 U.S.C.A. (I.R.C.1954) § 1348(b) (1).
93. 26 U.S.C.A. (I.R.C.1954) § 101(b)(2) (B).
94. 26 U.S.C.A. (I.R.C.1954) §§ 401(a), 403(a), 405(a).
95. 26 U.S.C.A. (I.R.C.1954) § 501(a).

(1) provided for contributions to an employee's trust described in section 401(a), 403(a), or 405(a) of the Internal Revenue Code of 1954 which is exempt from tax under section 501(a) of such Code, or

(2) was maintained as part of an arrangement under which an employee was permitted to elect to receive part of his compensation in one or more alternative forms if one of such forms results in the inclusion of amounts in income under the Internal Revenue Code of 1954.

(c) Administration of law with respect to certain plans.—

(1) Administration in the case of plans described in subsection (b).—Until salary reduction regulations have been issued in final form, the law with respect to plans or arrangements described in subsection (b) shall be administered—

(A) without regard to the proposed salary reduction regulations (37 FR 25938) and without regard to any other proposed salary reduction regulations, and

(B) in the manner in which such law was administered before January 1, 1972.

(2) Administration in the case of qualified profit-sharing plans.—In the case of plans or arrangements described in subsection (b), in applying this section to the tax treatment of contributions to qualified profit-sharing plans where the contributed amounts are distributable only after a period of deferral, the law shall be administered in a manner consistent with—

(A) Revenue Ruling 56-497 (1956—2 C.B. 284),

(B) Revenue Ruling 63-180 (1963—2 C.B. 189), and

(C) Revenue Ruling 68-89 (1968—1 C.B. 402).

(d) Limitation on retroactivity of final regulations.—In the case of any salary reduction regulations which become final after December 31, 1976—

(1) for purposes of chapter 1 of the Internal Revenue Code of 1954 [96] (relating to normal taxes and surtaxes), such regulations shall not apply before January 1, 1977; and

(2) for purposes of chapter 21 of such Code [97] (relating to Federal Insurance Contributions Act) and for purposes of chapter 24 of such Code [98] (relating to collection of income tax at source on wages), such regulations shall not apply before the day on which such regulations are issued in final form.

(e) Salary reduction regulations defined.—For purposes of this section, the term "salary reduction regulations" means regulations dealing with the includibility in gross income (at the time of contribution) of amounts contributed to a plan which includes a trust that qualifies under section 401(a), or a plan described in section 403(a) or 405(a), including plans or arrangements described in subsection (b)(2), if the contribution is made under an arrangement under which the contribution will be made only if the employee

96. 26 U.S.C.A. (I.R.C.1954) § 1 et seq.

97. 26 U.S.C.A. (I.R.C.1954) § 3101 et seq.

98. 26 U.S.C.A. (I.R.C.1954) § 3401 et seq.

elects to receive a reduction in his compensation or to forego an increase in his compensation, or under an arrangement under which the employee is permitted to elect to receive part of his compensation in one or more alternative forms (if one of such forms results in the inclusion of amounts in income under the Internal Revenue Code of 1954).

SEC. 2007. RULES FOR CERTAIN NEGOTIATED PLANS.

(a) Treatment of certain participants in the plan.—Section 404 (c) [99] (relating to certain negotiated plans) is amended by inserting after the first sentence the following new sentences: "For purposes of this chapter and subtitle B, in the case of any individual who before July 1, 1974, was a participant in a plan described in the preceding sentence—

"(A) such individual, if he is or was an employee within the meaning of section 401(c)(1), shall be treated (with respect to service covered by the plan) as being an employee other than an employee within the meaning of section 401(c)(1) and as being an employee of a participating employer under the plan,

"(B) earnings derived from service covered by the plan shall be treated as not being earned income within the meaning of section 401(c)(2), and

"(C) such individual shall be treated as an employee of a participating employer under the plan with respect to service before July 1, 1975, covered by the plan.

Section 277 (relating to deductions incurred by certain membership organizations in transactions with members) does not apply to any trust described in this subsection.".

(b) Other amendments to section 404(c)(1).—

(1) Paragraph (1) of the first sentence of section 404(c) is amended [1] by striking out "and pensions" and inserting in lieu thereof "or pensions".

(2) The last sentence of section 404(c) [2] is amended by striking out "This subsection" and inserting in lieu thereof "The first and third sentences of this subsection".

(c) Effective date.—The amendments made by this section shall apply to taxable years ending on or after June 30, 1972.

SEC. 2008. CERTAIN ARMED FORCES SURVIVOR ANNUITIES.

(a) In general.—Section 122(a) [3] (relating to certain reduced uniform services retired pay) is amended to read as follows:

"(a) General rule.—In the case of a member or former member of the uniformed services of the United States, gross income does not include the amount of any reduction in his retired or retainer pay pursuant to the provisions of chapter 73 of title 10, United States Code.".

(b) Technical amendments.—

(1) Section 122(b)(2) [4] is amended by striking out "section 1438" in subparagraph (B) and inserting in lieu thereof "section 1438 or 1452(d)".

99. 26 U.S.C.A. (I.R.C.1954) § 404(c).
1. 26 U.S.C.A. (I.R.C.1954) § 404(c)(1).
2. 26 U.S.C.A. (I.R.C.1954) § 404(c).
3. 26 U.S.C.A. (I.R.C.1954) § 122(a).
4. 26 U.S.C.A. (I.R.C.1954) § 122(b)(2).

the $50,000 of illegal kickbacks during 1970 is disallowed under section 162(c)(2) whether or not X Corp. is prosecuted with respect to the kickbacks.

(c) *Kickbacks, rebates, and bribes under medicare and medicaid.* No deduction shall be allowed under section 162 (a) for any kickback, rebate, or bribe (whether or not illegal) made on or after December 10, 1971, by any provider of services, supplier, physician, or other person who furnishes items or services for which payment is or may be made under the Social Security Act, as amended, or in whole or in part out of Federal funds under a State plan approved under such Act, if such kickback, rebate, or bribe is made in connection with the furnishing of such items or services or the making or receipt of such payments. For purposes of this paragraph, a kickback includes a payment in consideration of the referral of a client, patient, or customer.

PAR. 5. Section 1.162-21 is revised to read as follows:

§ 1.162-21 Fines and penalties.

(a) *In general.* No deduction shall be allowed under section 162(a) for any fine or similar penalty paid to—

(1) The Government of the United States, a State, a territory or possession of the United States, the District of Columbia, or the Commonwealth of Puerto Rico;

(2) The government of a foreign country; or

(3) A political subdivision of, or corporation or other entity serving as an instrumentality of, any of the above.

(b) *Definition.* For purposes of this section a fine or similar penalty includes an amount—

(1) Paid pursuant to conviction or a plea of guilty or nolo contendere for a crime (felony or misdemeanor) in a criminal proceeding;

(2) Paid as a civil penalty imposed by Federal, State, or local law, including additions to tax and additional amounts and assessable penalties imposed by chapter 68 of the Internal Revenue Code of 1954;

(3) Paid in settlement of the taxpayer's actual or potential liability for a fine or penalty (civil or criminal); or

(4) Forfeited as collateral posted in connection with a proceeding which could result in imposition of such a fine or penalty.

Such amount does not include legal fees and related expenses paid or incurred in the defense of a prosecution or civil action arising from a violation of the law imposing the fine or civil penalty, nor court costs assessed against the taxpayer, or stenographic and printing charges. Such amount also does not include a sanction imposed to encourage prompt compliance with filing or other requirements if such sanction is really more in the nature of a late charge or interest charge than a fine, as, for example, in the case of a so-called penalty which is imposed with respect to the late payment of a State tax without regard to whether the delay in payment was for reasonable cause. Compensatory damages (including damages under section 4A of the Clayton Act (15 U.S.C. 15a), as amended) paid to a government do not constitute a fine or penalty.

(c) *Examples.* The application of this section may be illustrated by the following examples:

Example (1). In 1970, X Corp. was indicted under section 1 of the Sherman Anti-Trust Act (15 U.S.C. 1) for fixing and maintaining prices of certain electrical products. X Corp. was convicted and was fined $50,000. The United States sued X Corp. under section 4A of the Clayton Act (15 U.S.C. 15a) for $300,000, consisting of $100,000 in actual damages resulting from the price fixing of which X Corp. was convicted, and $200,000 in punitive damages. Pursuant to a final judgment entered in the civil action, X Corp. paid the United States $300,000 in damages. Section 162(f) precludes X Corp. from deducting the fine of $50,000 as a trade or business expense. Section 162(f) does not preclude it from deducting the $100,000 paid to the United States as actual damages. See section 162(g) and § 1.162-22 with respect to the $200,000 paid as punitive damages.

Example (2). In July 1971, oil was knowingly discharged in harmful quantities from a vessel of Y Corp. into the navigable waters of the United States in violation of 33 U.S.C. 1161(b)(2). In August 1971, the District Commander of the Coast Guard assessed a civil penalty under 33 U.S.C. 1161(b)(5) and 33 CFR 153.03(b)(1) of $10,000 against Y Corp. with respect to such discharge. In November 1971, Y Corp. paid $10,000 to the Coast Guard in payment of the civil penalty assessed by the District Commander. Section 162(f) precludes Y Corp. from deducting the $10,000 penalty.

PAR. 6. Section 1.212-1 is amended by adding a new paragraph (p) at the end thereof to read as follows:

§ 1.212-1 Nontrade or nonbusiness expenses.

* * * * *

(p) *Frustration of public policy.* The deduction of a payment will be disallowed under section 212 if the payment is of a type for which a deduction would be disallowed under section 162 (c), (f), or (g) and the regulations thereunder in the case of a business expense.

PAR. 7. Section 1.471-3 is revised to read as follows:

§ 1.471-3 Inventories at cost.

Cost means:

(a) In the case of merchandise on hand at the beginning of the taxable year, the inventory price of such goods.

(b) In the case of merchandise purchased since the beginning of the taxable year, the invoice price less trade or other discounts, except strictly cash discounts approximating a fair interest rate, which may be deducted or not at the option of the taxpayer, provided a consistent course is followed. To this net invoice price should be added transportation or other necessary charges incurred in acquiring possession of the goods.

(c) In the case of merchandise produced by the taxpayer since the beginning of the taxable year, (1) the cost of raw materials and supplies entering into or consumed in connection with the product, (2) expenditures for direct labor, (3) indirect expenses incident to and necessary for the production of the particular article, including in such indirect expenses a reasonable proportion of management expenses, but not including any cost of selling or return on capital, whether by way of interest or profit.

(d) In any industry in which the usual rules for computation of cost of production are inapplicable, costs may be approximated upon such basis as may be reasonable and in conformity with established trade practice in the particular industry. Among such cases are: (1) Farmers and raisers of livestock (see § 1.471-6); (2) miners and manufacturers who by a single process or uniform series of processes derive a product of two or more kinds, sizes, or grades, the unit cost of which is substantially alike (see § 1.471-7); and (3) retail merchants who use what is known as the "retail method" in ascertaining approximate cost (see § 1.471-8).

Notwithstanding the other rules of this section, cost shall not include an amount which is of a type for which a deduction would be disallowed under section 162 (c), (f) or (g) and the regulations thereunder in the case of a business expense.

[FR Doc.72-20912 Filed 12-5-72;8:58 am]

[26 CFR Part 1]

INCOME TAX

Salary Reduction Agreements

Notice is hereby given that the regulations set forth in tentative form below are proposed to be prescribed by the Commissioner of Internal Revenue, with the approval of the Secretary of the Treasury or his delegate. Prior to the final adoption of such regulations, consideration will be given to any comments or suggestions pertaining thereto which are submitted in writing (preferably six copies) to the Commissioner of Internal Revenue, Attention: CC:LR:T, Washington, D.C. 20224, by February 5, 1973. Any written comments or suggestions not specifically designated as confidential in accordance with 26 CFR 601.601 (b) may be inspected by any person upon written request. Any person submitting written comments or suggestions who desires an opportunity to comment orally at a public hearing on these proposed regulations should submit his request, in writing, to the Commissioner by February 5, 1973. In such case, a public hearing will be held, and notice of the time, place, and date will be published in a subsequent issue of the FEDERAL REGISTER unless the person or persons who have requested a hearing withdraw their requests for a hearing before notice of the hearing has been filed with the Office of the Federal Register. The proposed regulations are to be issued under the authority contained in section 7805 of the

Internal Revenue Code of 1954 (68A Stat. 917; 26 U.S.C. 7805).

[SEAL] JOHNNIE M. WALTERS,
Commissioner of Internal Revenue.

In order to clarify the tax treatment of contributions to a trust described in section 401(a) of the Internal Revenue Code of 1954, amounts paid to purchase an annuity contract for an employee, and funds contributed to qualified bond purchase plans as the result of a "salary reduction" agreement, the Income Tax Regulations (26 CFR Part 1) under section 402 (relating to the taxability of beneficiary of employees' trust), section 403 (relating to the taxation of employee annuities), and section 405 (relating to qualified bond purchase plans) of the Code are amended to read as follows:

PARAGRAPH 1. Paragraph (a)(1)(i) of § 1.402(a)-1 is amended to read as follows:

§ 1.402(a)-1 Taxability of beneficiary under a trust which meets the requirements of section 401(a).

(a) *In general.* (1)(i) Section 402 relates to the taxation of the beneficiary of an employees' trust. If an employer makes a contribution for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust is exempt under section 501(a), the employee is not required to include such contribution in his income except for the year or years in which such contribution is distributed or made available to him. However, see section 1379(b) of the Code and the regulations thereunder for the inclusion of excess contributions made by an electing small business corporation in the gross income of certain shareholder-employees for a year or years prior to distribution. It is immaterial in the case of contributions to an exempt trust whether the employee's rights in the contributions to the trust are forfeitable or nonforfeitable either at the time the contribution is made to the trust or thereafter. Whether a contribution to an exempt trust is made by the employer or the employee must be determined on the basis of the particular facts and circumstances of the individual case. An amount contributed to an exempt trust will, except as otherwise provided in this subdivision, be considered to have been contributed by the employee if at his individual option such amount was so contributed in return for a reduction in his basic or regular compensation or in lieu of an increase in such compensation. The preceding sentence shall not apply to an amount contributed to an exempt trust either (*a*) in a taxable year of the employee ending prior to January 1, 1972, or (*b*) at any time prior to December 6, 1972, where the employee has relied upon a ruling by the Commissioner to him or his employer that such amount will be treated as the contribution of the employer.

* * * * *

PAR. 2. Paragraph (a) of § 1.403(a)-1 is amended to read as follows:

§ 1.403(a)-1 Taxability of beneficiary under a qualified annuity plan.

(a) An employee or retired or former employee for whom an annuity contract is purchased by his employer is not required to include in his gross income the amount paid for the contract at the time such amount is paid (except to the extent a shareholder-employee of an electing small business corporation must include excess contributions paid on his behalf in the year paid under section 1379(b)), whether or not his rights to the contract are forfeitable, if the annuity contract is purchased under a plan which meets the requirements of section 404(a)(2). For purposes of the preceding sentence, it is immaterial whether the employer deducts the amounts paid (other than certain amounts paid on behalf of a shareholder-employee by an electing small business corporation) for the contract under such section 404(a)(2). Whether an annuity contract is purchased under a qualified plan by the employer or the employee must be determined on the basis of the particular facts and circumstances of the individual case. An annuity contract will, except as otherwise provided in this subdivision, be considered to have been purchased by the employee if at his individual option, and to the extent that, an amount is paid for such a contract in return for a reduction in his basic or regular compensation or in lieu of an increase in such compensation. The preceding sentence shall not apply to an amount paid for an annuity contract under a qualified plan either (1) in a taxable year of the employee ending prior to January 1, 1972, or (2) at any time prior to December 6, 1972, where the employee has relied upon a ruling by the Commissioner to him or his employer that such amount will be treated as the contribution of the employer. See § 1.403(b)-1 for rules relating to annuity contracts which are not purchased under qualified plans but which are purchased by organizations described in section 501(c)(3) and exempt under section 501(a) or which are purchased for employees who perform services for certain public schools.

* * * * *

PAR. 3. Paragraph (a)(1) of § 1.405-3 is amended to read as follows:

§ 1.405-3 Taxation of retirement bonds.

(a) *In general.* (1) As in the case of employer contributions under a qualified pension, annuity, profit-sharing, or stock bonus plan, employer contributions on behalf of his common-law employees under a qualified bond purchase plan are not includible in the gross income of the employees when made (except to the extent includible in the gross income of a shareholder-employee of an electing small business corporation in the year paid under section 1379(b)), and employer contributions on behalf of self-employed individuals are deductible as provided in section 405(c) and § 1.405-2. Whether a contribution under a qualified bond purchase plan is made by the employer or the employee must be determined on the basis of the particular facts and circumstances of the individual case. An amount contributed under a qualified bond purchase plan will, except as otherwise provided in this subdivision, be considered to have been contributed by the employee if at his individual option such amount was so contributed in return for a reduction in his basic or regular compensation or in lieu of an increase in such compensation. The preceding sentence shall not apply to an amount contributed under a qualified bond purchase plan either (i) in a taxable year of the employee ending prior to January 1, 1972, or (ii) at any time prior to December 6, 1972, where the employee has relied upon a ruling by the Commissioner to him or his employer that such amount will be treated as the contribution of the employer. Further an employee or his beneficiary does not realize gross income upon the receipt of a retirement bond pursuant to a qualified bond purchase plan or from a trust described in section 401(a) which is exempt from tax under section 501(a). Upon redemption of such a bond, ordinary income will be realized to the extent the proceeds thereof exceed the basis (determined in accordance with paragraph (b) of this section) of the bond. The proceeds of a retirement bond are not entitled to the special tax treatment of section 72(n) and § 1.72-18.

* * * * *

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DEPARTMENT OF AGRICULTURE

Agricultural Marketing Service

[7 CFR Part 909]

GRAPEFRUIT GROWN IN ARIZONA AND DESIGNATED PART OF CALIFORNIA

Limitations of Handling

Notice is hereby given that the Department is giving consideration to the following proposal, which would limit the handling of fresh grapefruit by establishing grades and sizes, recommended by the Administrative Committee, established pursuant to Marketing Order No. 909 (7 CFR Part 909), regulating the handling of fresh grapefruit grown in Arizona and designated part of California. This program is effective under the Agricultural Marketing Agreement Act of 1937, as amended (7 U.S.C. 601-674).

All persons who desire to submit written data, views, or arguments, in connection with the proposal should file the same in quadruplicate with the Hearing Clerk, Room 112A, U.S. Department of Agriculture, Washington, DC 20250, not later than the 10th day after the publication of this notice in the FEDERAL REGISTER. All written submissions made pursuant to this notice will be made available accrued benefit is to be a fraction of the amount the employee would receive at normal retirement age, under the plan as in effect at the time for which the accrued benefit is to be determined. (As discussed below under F. Insurance, a collectively-bargained plan in which the employer participates in the setting of defined benefits is a defined benefit plan, even though the collective bargaining agreement may specify only the level of contributions.) In making this computation, the retirement benefit is to be computed as though the employee continued to earn the same rate of compensation annually as he had earned during the years which would have been taken into account under the plan, had the employee retired on the date in question. This amount is then to be multiplied by a fraction, the numerator of which is the employee's total number of years of active participation in the plan up to the date when the computation is being made and the denominator of which is the total number of years of active participation he would have if he continued his employment until normal retirement age.[9] The term "normal retirement age" is to be defined by regulations. It is expected that a minimum and maximum age will be taken (perhaps 55 and 65) and that the "normal retirement age" in this range will be based on the age at which the retirement benefit has the greatest actuarial value.

In the case of a defined benefit pension plan funded through an insurance contract, the accrued benefit is to be the annuity which might be purchased by the cash surrender value of the policy. In the case of a variable annuity plan, the term accrued benefit is to be defined by regulations.

Allocations between employer and employee contributions.—In plans where there are both employer and employee contributions, it will be necessary to allocate the accrued benefit between the portion derived from the employer contributions, and the portion derived from the employee contributions. This allocation may have to be made because the employee is always fully vested with respect to amounts attributable to his own contributions but not necessarily with respect to those of the employer. Also, information of this type would be needed if an employee, upon leaving employment, desires to withdraw his own contributions.

In the case of any plan other than a defined benefit pension plan, the accrued benefit derived from the employee's contributions under the bill is the amount in his own separate account. If employee and employer contributions were not accounted for separately, the employee-contributed portion of the total accrued benefit would be treated as the fraction of the total which is the ratio of employee to total contributions (after taking account of withdrawals, and, to the extent necessary, the timing of the contributions).

In the case of a defined benefit pension plan which provides an annual benefit in the form of a single life annuity commencing at normal retirement age (without ancillary benefits), the accrued benefit derived from mandatory employee contributions would be treated as the total amount of the employee's "accumulated contributions" multiplied by a conversion factor.[10] In general, the conversion factor, which initially is to be fixed at 10 percent for a normal retirement age of 65, is to be

[9] The fraction may not exceed one, under the committee bill, since at this point the employee would receive the full pension to which he was entitled under the plan.

[10] Voluntary employee contributions are to be treated the same as a separate account.

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No. 93-383

General rules

Under the conference substitute [1] plans must provide full and immediate vesting in benefits derived from employee contributions.

With respect to employer contributions, the plan (except class year plans) must meet one of three alternative standards. Two of those, the 5- to 15-year graded standard and the 10-year/100-percent standard are the same as provided in the House bill (and briefly described above). The third standard under the conference substitute is a modification of the House-bill "rule of 45". As under the House rule, under the modified rule of 45, an employee with 5 or more years of covered service must be at least 50 percent vested when the sum of his age and years of covered service total 45, and there must be provision for at least 10 percent additional vesting for each year of covered service thereafter. Unlike the House bill, however, each employee with 10 years of covered service (regardless of his age) must be at least 50 percent vested and there must be provision for 10 percent additional vesting for each year of service thereafter.

In addition, all plans would have to meet the requirement of present law that an employee must be 100 percent vested in his accrued benefit when he attains the normal or stated retirement age (or actually retires).

Service credited for vesting purposes

Generally, under the conference substitute, once an employee becomes eligible to participate in a pension plan, all his years of service with an employer (including preparticipation service, and service performed before the effective date of the Act) are to be taken into account for purposes of determining his place on the vesting schedule. However, the plan may ignore periods for which the employee declined to make mandatory contributions, and periods for which the employer did not maintain the plan or a predecessor plan, as defined in Treasury regulations (i.e., if the plan provides past service credits for purposes of benefit accrual, it must also provide past service credits for purposes of participation and vesting).

Generally, the plan may also ignore service performed before age 22; however, if a plan elects to use the rule of 45, service before age 22 may be ignored only if the employee was not a participant in the plan during the years before age 22.

The plan may also exclude part-time or seasonal service (i.e., generally years when the employee had less than 1,000 hours of service).

Also, if the employee has had a "break in service", his service performed prior to the break may be ignored to the extent permitted under the "break in service" rules (discussed below).

Service performed prior to January 1, 1971, may be ignored by the plan, unless (and until) the employee has at least 3 years of service after December 31, 1970.

Year of service defined

In general, under the conference substitute, the rules with respect to "year of service", seasonal and part-time employees, etc., are the same

[1] Unless otherwise indicated, the rules with respect to vesting appear in both title I and title II of the conference substitute. Unless otherwise indicated, the regulations with respect to vesting are to be written by the Secretary of the Treasury, or his delegate.

House Conference
Report 93-1280

for purposes of the vesting schedule as they are for purposes of participation (i.e., generally 1,000 hours of service except for seasonal industries, where the customary work year is less than 1,000 hours). However, the relevant year for purposes of applying the vesting schedule may be any 12-month period provided under the plan (plan year, calendar year, etc.) regardless of the anniversary date of the participant's employment (even though the anniversary date is the measuring point for purposes of the participation requirements for an employee's first year).

For purposes of benefit accrual, in general, the plan may use any definition of the term "year of service" which the plan applies on a reasonable and consistent basis (subject to Department of Labor regulations). (Of course, the "year" for benefit accrual purposes cannot exceed the customary work year for the industry involved.) However, the plan must accrue benefits for less than full time service on at least a pro rata basis. For example, if a plan requires 2,000 hours of service for a full benefit accrual (50 weeks of 40 hours each) then the plan would have to accrue at least 75 percent of a full benefit for a participant with 1,500 hours of service. Generally, a plan would not be required to accrue any benefit for years in which the participant had less than 1,000 hours of service. In the case of industries or occupations where the customary year is less than 1,000 hours (for example, the tuna fishing industry, or the winter season employees of a ski lodge), the rules with respect to benefit accrual would be determined under Department of Labor regulations. As previously indicated a special rule is provided for the maritime industries.

Breaks in service

Under the conference substitute, a 1-year break in service occurs in any calendar year, plan year, or other consecutive 12-month period designated by the plan and applied on a consistent basis (and not prohibited under Labor Department regulations) in which the employee has no more than 500 hours of service. For example, if the plan is on a calendar year basis, and the employee works 1,000 hours in 1976, 501 hours in 1977, 501 hours in 1978, and 1,000 hours or more in 1979, the employee would not have a break in service (although the plan would not be required to accrue benefits or give vesting schedule credit for 1977 or 1978).

The rules with respect to breaks in service for vesting and benefit accrual purposes may be summarized as follows:

(1) If an employee has a 1-year break in service, the plan may require (for administrative reasons) a 1-year waiting period before his pre-break and post-break service must be aggregated under the plan. However, once the employee has completed this waiting period, he must receive credit for that year (for purposes of vesting and accrued benefit).

(2) In the case of an individual account plan (including a plan funded solely by individual insurance contracts, as well as a "target benefit plan") if any employee has a 1-year break in service, his vesting percentage in pre-break benefit accruals does not have to be increased as a result of post-break service.

(3) Subject to rules (1) and (2), once an employee has achieved any percentage of vesting, then all of his pre-break and post-break service must be aggregated for all purposes.

(4) For all nonvested employees (and subject to rules (1) and (2)), the employee would not lose credits for pre-break service until his period of absence equaled his years of covered service. Under this "rule of parity" for example, if a nonvested employee had three years of service with the employer, and then had a break in service of 2 years, he could return, and after fulfilling his 1-year reentry requirement, he would have 4 years of covered service, because his pre-break and post-break srevice would be aggregated.[2]

For years beginning prior to the effective date of the vesting provisions, a plan may apply the break-in-service rules provided under the plan, as in effect from time to time. However, no plan amendment made after January 1, 1974, may provide for break-in-service rules which are less beneficial to any employee than the rules in effect under the plan on that date, unless the amendment complies with the break-in-service rules established under this bill.

The principles of some of the rules outlined above may be illustrated as follows: For example, assume a plan is on a calendar year basis, and an employee with a 1-year break in service reenters employment on November 1, 1976, works 200 hours in 1976, and 1,700 hours by November 1, 1977. In this case, the employee would be eligible to reenter the plan on November 1, 1977, his pre-break and post-break service would be aggregated, he would advance one year on the vesting schedule for 1977, and he would also accrue benefits for 1977. On the other hand, if the employee reentered employment on March 1, 1976, worked 1,700 hours before December 31, 1976, and was not separated from service by March 1, 1977, he would be eligible to reenter the plan on March 1, 1977, advance one year on the vesting schedule for his 1976 service, and the plan would have to provide at least a partial benefit accrual for 1976.

Predecessor employer

The rules concerning service with a predecessor employer are the same for purposes of vesting and benefit accrual as the rules for purposes of participation, discussed above.

Multiemployer plans

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Under the conference substitute, service with any employer, for any year in which the employer is a member of the plan, is to be counted for purposes of vesting as if all employers who are parties to the plan were a single employer.

Permitted forfeitures of vested rights

Under the conference substitute, except as outlined below, an employee's rights, once vested, are not to be forfeitable for any reason. An employee's rights to benefits attributable to his own contributions may never be forfeited.

(1) The plan may provide that an employee's vested rights to benefits attributable to employer contributions may be forfeited on account of the employee's death (unless a "joint and survivor" annuity is to be provided).

(2) Also, the plan may provide that payment of benefits attributable to employer contributions may be suspended for any period in which

[2] Also, in the case of a defined benefit plan, the employee would have at least 3 years of accrued benefits under the plan (2 years of accrued benefits due to his pre-break participation and 1 year of benefits accrued with respect to the 1 year reentry period).

the employee is reemployed by the same employer under whose plan the benefits are being paid (in the case of a single employer plan). In the case of a multiemployer plan, however, a suspension of benefit payments is permitted when the employee is employed in the same industry, in the same trade or craft and also in the same geographical area covered under the contract, as was the case immediately before he retired. Regulations with respect to the suspension of benefits are to be prescribed by the Department of Labor.

(3) A plan amendment may reduce an employee's vested or nonvested accrued benefit attributable to employer contributions, but only for the current year, and only if the amendment is adopted within 2½ months from the close of the plan year in question (without regard to any extensions). In the case of a multiemployer plan, the retroactive amendment may effect the current year, and the two immediately preceding years (thus, a multiemployer plan amendment adopted by December 31, 1978, could effect plan benefits for 1976, if the plan was on a calendar year). However, no plan amendment which reduces accrued benefits is permitted unless the Secretary of Labor has 90 days prior notice of the proposed amendment, and approves it (or fails to disapprove it). No such approval is to be granted, except to prevent substantial economic hardship, including a serious danger that the plan will be terminated unless the amendment is allowed. In addition, it must be found that the economic hardship cannot be overcome by means of a funding variance. Subject to these rules, no plan amendment may retroactively reduce the accrued benefit of any participant (whether or not that benefit is vested).

(4) A plan may provide that an employee's rights to benefits from employer contributions may be forfeited where the employee is less than 50 percent vested in these benefits and withdraws all or any part of his own mandatory contributions to the plan. However, the plan must also provide a "buy back" rule, i.e., that the employee's forfeited benefits will be fully restored if the employee repays the withdrawn contributions (with interest of 5-percent per annum, compounded annually) to the plan.

In the case of a plan which does not provide for mandatory contributions after the date of enactment, the plan may provide, in this case, that the employee will forfeit a proportionate part of his pre-date-of-enactment accrued benefits derived from employer contributions even if he is 50 percent or more vested in these benefits. Also, the plan is not required to have a "buy back" clause with respect to the withdrawal of pre-enactment contributions. Additional regulations in this area are to be prescribed by the Secretary of the Treasury, or his delegate.

(5) A plan may provide for the "cash out" of an employee's accrued benefit. In other words, the plan may pay out, in a lump sum, the entire value of an employee's vested accrued benefit. (However, portability is available to the employee because other provisions of the bill permit the employee to reinvest in an individual retirement account on a tax-sheltered basis.) If the plan does make such a cash-out, then the plan would not be required to vest the employee in his accrued benefits which are not vested at the time he separates from the service, if the employee is later reemployed. (However, the employee's prebreak service would have to be taken into account for all other pur-

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elected by any similarly situated plan participant, and (2) the other contributions or benefits provided by the plan bear a uniform relationship to the compensation of plan participants. Of course, the committee intends that a cafeteria plan will not be considered to be discriminatory where the other contributions or benefits provided (or total contributions or benefits in the case of a plan which does not provide health benefits) for a highly compensated employee are a lower percentage of that employee's compensation than the plan provides for employees who are not highly compensated.

Under the bill, a plan is considered to meet all discrimination tests if it is maintained under an agreement which the Secretary of the Treasury finds to be a collective bargaining agreement between employee representatives and one or more employers.

In testing a cafeteria plan for discriminatory coverage of employees and discriminatory contributions or benefits, the bill provides that all employees who are employed by a commonly controlled group of businesses are treated as if they were employed by a single employer. The rules for aggregating employees of businesses under common control are the same as the rules which are used in testing tax-qualified pension plans for discrimination (sec. 414 (b) and (c)). The committee intends that, where an employer maintains two or more cafeteria plans, the employer may choose to have the plans considered as a single plan for purposes of the discrimination tests.

The House bill contains an identical provision except for minor technical changes.

Effective date

The amendment is effective for taxable years beginning after the December 31, 1978.

Revenue effect

This provision will have no effect upon budget receipts.

5. Tax treatment of cash or deferred arrangements (sec. 135 of the bill and new secs. 402(a)(7) and 410(b)(3) of the Code)

Present law

Under present law, the benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated, and the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. In the case of a tax-qualified cash or deferred profit-sharing plan, the employer gives an employee the choice of (1) being paid a specified amount in cash as current compensation, or (2) having that amount contributed to the plan. Rev. Rul. 56-497, 1956-2 C.B. 284 upheld the tax-qualified status of a cash or deferred profit-sharing plan where, in operation, over one-half of the employees who elected profit-sharing contributions (deferral), rather than current compensation, were among the lowest paid two-thirds of the employees who had met the plan's 3-year eligibility requirement. (See also Rev. Rul. 63-180; 1963-2 C.B. 189, and Rev. Rul. 68-89, 1968-1 C.B. 402.)

On December 6, 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of employees

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covered by cash or deferred profit-sharing plans. These proposed regulations were withdrawn in July, 1978.[1] Under the rules in effect at the time of the proposal, an employee was not taxed currently on amounts he chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.

In order to allow time for Congressional study of this area, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, is governed under the law as it was applied prior to January 1, 1972,[2] and this treatment was to continue at least through December 31, 1976, or (if later) until regulations are issued in final form in this area, which would change the pre-1972 administration of the law. Section 2006 of ERISA provides that these regulations, if issued, are not to be retroactive for purposes of social security taxes or the Federal withholding taxes, and are not to be retroactive prior to January 1, 1977, for Federal income tax purposes.

In the case of plans not in existence on June 27, 1974, contributions to a cash and deferred profit-sharing plan are treated as employee contributions (until January 1, 1977, or until new regulations are prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law before Congress has determined what the law should be in the future.

The Tax Reform Act of 1976 (sec. 1506) extended the temporary freeze of the status quo until January 1, 1978, in order to allow additional time for Congressional study of this area.[3]

Reasons for change

Since the enactment of ERISA the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1 1977. The committee believes that the uncertainty caused by the present state of the law has created the need for a permanent solution which permits employers to establish new cash or deferred arrangements. Also, the committee believes that present law discriminates against employers who had not established such arrangements by June 27, 1974.

Explanation of provision

The committee's bill adds new provisions to the Code (secs. 402(a)(7) and 410(b)(3)) to permit employers to establish tax-qualified cash or deferred profit-sharing plans (or stock bonus plans). In addi-

[1] The committee understands that the withdrawal of the proposed regulations was not intended to represent a change in the Internal Revenue Service's position.

[2] Accordingly, employer contributions to these cash or deferred profit-sharing plans are not includible in the income of covered employees, provided the plans satisfy the requirements of pre-1972 law and otherwise comply with the standards of the Code for tax-qualified plans.

[3] The Tax Treatment Extension Act (H.R. 9251), different versions of which passed the House and the Senate, contains a provision which would extend the freeze of the status quo until January 1, 1980.

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tion, it provides a transitional rule to permit plans in existence on June 27, 1974 to rely on certain pre-1972 revenue rulings until plan years beginning in 1980.

The bill provides that a participant in a qualified cash or deferred arrangement will not have to include in income any employer contribution to the plan merely because he could have elected to receive such amount in cash instead. For the cash or deferred arrangement to be a tax-qualified plan, it must satisfy the normal pension plan qualification rules. In addition, it must satisfy the following requirements: (1) it must not permit the distribution of amounts attributable to employer conributions merely because of the completion of a stated period of plan participation or the passage of a fixed period of time (unlike profit-sharing plans in general, where distributions may be made in the third calendar year following the calendar year of the employer's contribution), and (2) all amounts contributed by the employer pursuant to an employee's election must be nonforfeitable at all times.

Special nondiscrimination rules are provided for these arrangements in lieu of the normal rules to test for discrimination as to actual plan participation or as to contributions to the plan. Under these rules, a cash or deferred arrangement will meet these nondiscrimination requirements for qualification for a plan year if (1) the actual deferral percentage for the highest paid one-third of all participants does not exceed the deferral percentage for the other eligible employees by more than 50 percent, or (2) the actual deferral percentage for the highest paid one-third of all participants does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. (If this latter test is used, the actual deferral percentage for the highest paid one-third cannot exceed the actual deferral percentage of all other eligible employees by more than 150 percent. Paid one-third of all participants, only amounts considered as compensation under the provisions of the plan are taken into account. Therefore, the plan would have to have participation by employees in the lower paid group in order to obtain any deferral for the highest paid one-third.

The House bill, which was designed as a temporary solution, would have permitted new cash or deferred arrangements to be tax-qualified if they satisfied the law with respect to cash or deferred arrangements as it was administered before January 1, 1972.

Effective date

The amendment is effective for taxable years beginning after December 31, 1979; however, a transitional rule is provided for those cash or deferred arrangements in existence on January 27, 1974 under which their qualified status for plan years beginning before January 1, 1980 shall be determined in a manner consistent with Rev. Rul. 56-497 (1956-2 C.B. 284), Rev. Rul. 63-180 (1963-2 C.B. 189), and Rev. Rul. 68-89 (1968-1 C.B. 402).

Revenue effect

This provision will have a negligible effect upon budget receipts.

In testing a cafeteria plan for discriminatory coverage of employees and discriminatory contributions or benefits, the bill provides that all employees who are employed by a commonly controlled group of businesses are treated as if they were employed by a single employer. The rules for aggregating employees of businesses under common control are the same as the rules which are used in testing tax-qualified pension plans for discrimination (sec. 414 (b) and (c)). The committee intends that, where an employer maintains two or more cafeteria plans, the employer may choose to have the plans considered as a single plan for purposes of the discrimination tests.

Effective date

The amendment is effective for taxable years beginning after the December 31, 1978.

Revenue effect

This provision will have no effect upon budget receipts.

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5. Tax treatment of cash or deferred profit-sharing plans (sec. 125 of the bill)

Present law

Under present law, the benefits or contributions under a tax-qualified plan must not discriminate in favor of employees who are officers, shareholders, or highly compensated, and the plan must meet standards designed to assure that the classification of employees covered by the plan is not discriminatory. In the case of a tax-qualified pensation, or (2) having that amount contributed to the plan. Rev. cash or deferred profit-sharing plan, the employer gives an employee the choice of (1) being paid a specified amount in cash as current com-Rul. 56–497, 1956–2 C.B. 284 upheld the tax-qualified status of a cash or deferred profit-sharing plan by providing that the plan did not engage in prohibited discrimination where, in operation, over one-half of the employees who elected profit-sharing contributions (deferral), rather than current compensation, were among the lowest paid two-thirds of the employees who had met the plan's 3-year eligibility requirement. (See also Rev. Rul. 63–180; 1963–2 C.B. 189, and Rev. Rul. 68–89, 1968–1 C.B. 402.)

On December 6, 1972, the Internal Revenue Service issued proposed regulations which called into question the tax treatment of employees covered by cash or deferred profit-sharing plans. These proposed regulations were withdrawn in July, 1978.[1] Under the rules in effect at the time of the proposal, an employee was not taxed currently on amounts he chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.

In order to allow time for Congressional study of this area, section 2006 of the Employee Retirement Income Security Act of 1974 (ERISA) provided for a temporary freeze of the status quo. Under ERISA, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, is governed under the laws as it was applied prior to January 1, 1972,[2] and this treatment was to continue at least through December 31, 1976, or (if later) until regulations are issued in final form in this area, which would change the pre-1972 administration of the law. Section 2006 of ERISA provides that these regulations, if issued, are not to be retroactive for purposes

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of social security taxes or the Federal withholding taxes, and are not to be retroactive prior to January 1, 1977, for Federal income tax purposes.

In the case of plans not in existence on June 27, 1974, contributions to a cash and deferred profit-sharing plan are treated as employee ✓

[1] The committee understands that the withdrawal of the proposed regulations was not intended to represent a change in the Internal Reveue Service's position.

[2] Accordingly, employer contributions to these cash or deferred profit-sharing plans are not includible in the income of covered employees, provided the plans satisfy the requirements of pre-1972 law and otherwise comply with the standards of the Code for tax-qualified plans.

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contributions (until January 1, 1977, or until new regulations are prescribed in this area). This was intended to prevent a situation where a new plan might begin in reliance on pre-1972 law before Congress has determined what the law should be in the future. ✓

The Tax Reform Act of 1976 (sec. 1506) extended the temporary freeze of the status quo until January 1, 1978, in order to allow additional time for Congressional study of this area.[3]

Reasons for change

Since the enactment of ERISA, the freeze of the status quo treatment of cash or deferred profit-sharing plans has prevented employers from setting up new plans of this type for their employees. Originally, it was thought that a relatively short period of time would be needed for Congressional study and that a permanent solution would be in place by January 1, 1977. The committee believes that the uncertainty caused by the present state of the law has created the need for an interim solution which permits employers to establish new cash or deferred profit-sharing plans pending the adoption of a permanent solution in this area. Also, the committee believes that present law discriminates against employers who had not established cash or deferred profit-sharing plans by June 27, 1974.

Explanation of provision

The bill will change present law with respect to new cash or deferred profit-sharing plans by permitting those plans to be tax-qualified, by permitting trusts forming a part of those plans to be tax-exempt, and by permitting employees covered by such plans to exclude from income employer contributions to these arrangements, provided the plans satisfy the law with respect to cash or deferred profit-sharing plans as it was administered before January 1, 1972. It is the committee's intention that the Service will administer the law in a manner consistent with Rev. Rul. 56-497, 1956-2 C.B. 284; Rev. Rul. 63-180, 1963-2 C.B. 189; and Rev. Rul. 68-89, 1968-1 C.B. 402. While the provisions of this bill relate only to the preceding published rulings, it is the intent of the committee that the law will also be administered in a manner consistent with any private ruling which had been issued prior to 1972 to the extent based on the published rulings. Accordingly, a cash or deferred profit-sharing plan which satisfies the requirements of these rulings for purposes of nondiscrimination and which otherwise complies with the standards of the Code for tax qualification will be considered tax-qualified and will not, merely because of its contribution or allocation formula, be considered to discriminate in favor of employees who are officers, shareholders, or highly compensated.

Effective date

The amendment is effective for taxable years beginning after December 31, 1977.

Revenue effect [3]

This provision will have no effect upon budget receipts because it is an extension of present law.

[3] The Tax Treatment Extension Act (H.R. 9251), different versions of which passed the House and the Senate, contains a provision which would extend the freeze of the status quo until January 1, 1980.

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E. Tax Shelter Provisions

1. Modifications of at risk provision (secs. 201–204 of the bill and secs. 465 and 704(d) of the Code)

Present law

Among the provisions of the Tax Reform Act of 1976 which deal with tax shelters are two "at risk" rules. These rules are designed to prevent a taxpayer from deducting losses in excess of his actual economic investment in the activity involved.

The first of these at risk rules—"the specific at risk rule"—applies to four specified activities: (1) farming; (2) exploring for, or exploiting, oil and natural gas resources; (3) holding, producing, or distributing motion picture films or video tapes; and (4) leasing of personal property (sec. 465). This specific at risk rule applies to all types of taxpayers other than regular corporations (that is, corporations which are not subchapter S corporations or personal holding companies).

Under the specific at risk rule, a taxpayer's loss for any taxable year from covered activities is limited to the amount the taxpayer has placed at risk and could actually lose from this activity. Initially, the amount at risk is generally the sum of (1) the taxpayer's cash contributions to the activity, (2) the adjusted basis of other property contributed to the activity, and (3) amounts borrowed for use in the activity with respect to which the taxpayer has personal liability for repayment. Generally, this amount is increased by the taxpayer's share of income and it is decreased by his share of losses and withdrawals from the activity.

The taxpayer is not generally to be considered at risk with respect to the proceeds (or his share of the proceeds) of a nonrecourse loan used directly or indirectly to finance his participation in the activity. Additional rules are provided to prevent avoidance of this rule by cross-collateralization of property involved in two different activities and borrowing from other participants in the same activity. Also, a taxpayer is not considered at risk to the extent his economic participation is protected from loss by guarantees, repurchase agreements or insurance (except casualty insurance).

Losses which may not be deducted for any taxable year because of the specific at risk rule are deferred and may be deducted in any subsequent year in which this at risk limitation does not prevent the deduction.

The House bill provides that employer contributions under a cafeteria plan generally are excluded from the employer's gross income to the extent that nontaxable benefits are elected. However, in the case of a highly compensated employee, amounts contributed under a cafeteria plan will be included in gross income for the taxable year in which the plan year ends, to the extent the individual could have elected taxable benefits unless the plan meets specified antidiscrimination standards with respect to coverage and eligibility and with respect to contributions or benefits. These rules apply for taxable years beginning after December 31, 1978.

Senate amendment.—The Senate amendment is the same as the House bill except for changes adding clarifying language, and making it clear that a plan must be in writing to be subject to the cafeteria plan rules. Thus, this provision will apply only when there is a written plan which provides employees a choice between taxable and nontaxable benefits. The taxation of benefits provided under other types of arrangements will be determined under existing law.

Conference agreement.—The conference agreement follows the Senate amendment.

16. Tax treatment of cash or deferred profit-sharing plans

House bill.—Under present law, the tax treatment of amounts contributed by an employer, to a cash or deferred profit-sharing plan, at the election of an employee, depends upon when the plan was established. Under a provision of the Employee Retirement Income Security Act of 1974 (ERISA), as amended by the Tax Reform Act of 1976, the tax treatment of contributions to cash or deferred profit-sharing plans in existence on June 27, 1974, is governed (until January 1, 1978) under the law as it was applied prior to 1972. (Under the rules in effect then, an employee was not taxed currently on amounts

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he chose to have contributed to a tax-qualified cash or deferred profit-sharing plan.) In the case of plans not in existence on June 27, 1974, contributions to a cash or deferred profit-sharing plan are treated as employee contributions (until January 1, 1978, or until new regulations are prescribed in this area.)

The House bill changes present law with respect to new cash or deferred profit-sharing plans by permitting those plans to be tax-qualified (for taxable years beginning after December 31, 1977) provided the plans satisfy the law with respect to cash or deferred profit-sharing plans as it was administered before January 1, 1972.

Senate amendment.—The Senate amendment provides that a participant in a qualified cash or deferred arrangement will not have to include in income any employer contribution to the plan merely because he could have elected to receive such amount in cash instead. For the cash or deferred arrangement to be a tax-qualified plan, it must satisfy the normal pension plan qualification rules. In addition, it must satisfy the following requirements: (1) it must not permit the distribution of amounts attributable to employer contributions merely because of the completion of a stated period of plan participation or the passage of a fixed period of time, and (2) all amounts contributed by the employer pursuant to an employee's election must be nonforfeitable at all times.

Special nondiscrimination rules are provided for these arrangements to test for discrimination as to actual plan participation or as to the

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amount of contributions to the plan. Under these rules, a cash or deferred arrangement will meet the nondiscrimination requirements for qualification for a plan year if (1) the actual deferral percentage for the highest paid one-third of all eligible employees does not exceed the actual deferral percentage for the other eligible employees by more than 50 percent, or)2) the actual deferral percentage for the highest paid one-third of all eligible employees does not exceed the actual deferral percentage of the other eligible employees by more than three percentage points. (If this latter test is used, the actual percentage for the highest paid one-third cannot exceed the actual deferral percentage of all other eligible employees by more than 150 percent.)

The Senate amendment is effective for taxable years beginning after December 31, 1979; however, a transitional rule is provided for those cash or deferred arrangements in existence on January 27, 1974 under which their qualified status for plan years beginning before January 1, 1980 shall be determined in a manner consistent with Rev. Rul. 56-497 (1956-2 C.B. 284), Rev. Rul. 63-180 (1963-2 C.B. 189), and Rev. Rul. 68-89 (1968-1 C.B. 402).

Conference agreement.—The conference agreement follows the Senate amendment.

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D. Employee Stock Ownership Plans

17. Employee stock ownership plans

House bill.—No provision.

Senate amendment.—(a) *Expiration date of TRASOP provisions.*—The Senate amendment makes the TRASOP provisions, as amended, part of the Code for the first time and makes them permanent by repealing the present law December 31, 1980, expiration date.

(b) *Qualification requirements for TRASOPs.*—The Senate amendment requires that all TRASOPs are to be tax-qualified plans if contributions are made for plan years beginning after December 31, 1978.

(c) *Date by which a TRASOP must be established for a plan year.*—The Senate amendment provides that a TRASOP may be treated as tax-qualified from its effective date even though the TRASOP is not actually established until the date for filing the employer's tax return for its taxable year (including extensions) in which the effective date falls.

(d) *Allocation of TRASOP contributions.*—Under present law, an employee who participates in a TRASOP at any time during the year for which an employer contribution is made is entitled to an allocation of the contribution. Under the Senate amendment, employer contributions to a TRASOP for a plan year generally are to be allocated in accordance with the rules governing the allocation of contributions to tax-qualified plans. In addition, the Senate amendment retains the present law requirement that the allocation of employer contributions to a TRASOP for a year must be made in proportion to total compensation of all participants sharing in the allocation for the plan year, taking into account only the first $100,000 of compensation for an employee.

(e) *Provisions relating to voting of employer securities by plan.*—The Senate amendment provides that if an ESOP or TRASOP holds employer stock issued by a corporation whose stock is "publicly traded," the plan must provide that the stock is to be voted by the