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Employee Benefit Provisions of the Economic Recovery Tax Act of 1981

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John H. Appel
Ronald C. Stansbury

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Employee Benefit Provisions of the Economic Recovery Tax Act of 1981

*John H. Appel**
*Ronald C. Stansbury***

The Economic Recovery Tax Act of 1981 effected many changes in the law of retirement programs. While the Tax Equity and Fiscal Responsibility Act of 1982 has modified some of these changes, the 1981 Act continues to be of great importance in this area. The authors offer an analytical discussion of the 1981 changes, noting wherever relevant the further modifications in the law brought about by the Tax Equity and Fiscal Responsibility Act of 1982.

ON AUGUST 13, 1981, President Reagan signed into law the Economic Recovery Tax Act of 1981 (ERTA).¹ ERTA has made important changes in the areas of individual retirement accounts, annuities and bonds, deductible employee contributions to qualified plans, and incentive stock options. ERTA also has effected new rules regarding the following types of plans: Keogh plans, Subchapter S plans, Simplified Employee Pension plans, employee stock ownership plans, other plans investing in employer stock, and miscellaneous fringe benefit plans. As is discussed in detail in this Article, these changes add a significant number of noteworthy employee benefits previously unavailable.

On September 3, 1982, President Reagan signed yet another piece of legislation affecting employee benefits, the Tax Equity and Fiscal Responsibility Act of 1982² (1982 Tax Equity Act). The 1982 Tax Equity Act continues the pattern of significant and almost annual revision of the law concerning retirement programs that has taken place since the enactment of the Employee Retire-

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1. Economic Recovery Tax Act of 1981, Pub. L. No. 97-34, 95 Stat. 172 (has been codified at scattered sections of 26 U.S.C.) [hereinafter cited as ERTA].

2. Tax Equity and Fiscal Responsibility Act of 1982, Pub. L. No. 97, — Stat. — (to be codified at scattered sections of 26 U.S.C.) [hereinafter cited as Tax Equity Act].

ment Income Security Act of 1974³ (ERISA). The changes in the employee benefit area made by the new law deal primarily with the following matters: a reduction in the maximum amounts which may be contributed to corporate retirement plans; an increase in corresponding contributions to plans for the self-employed so that the limits are the same as for corporate plans; and a redrawing of the line that formerly separated retirement plans for the self-employed from corporate plans. With few exceptions, the new line is drawn between so-called "top-heavy plans" which primarily benefit highly paid employees and owners of businesses, and all other retirement plans. A number of the old restrictions on retirement plans for the self-employed were eliminated while others became applicable to top-heavy plans or, in a few cases, to all plans. Beyond adjusting contribution levels and redrawing the corporate/self-employed line, however, the 1982 Tax Equity Act had a relatively minor impact upon the changes effected by ERTA. The rules regarding individual retirement accounts, deductible employee contributions to qualified plans, and incentive stock options were somewhat, but not greatly, affected. Furthermore, a number of the changes made by the 1982 Tax Equity Act, such as the attempt to create parity between retirement plans for the self-employed and those for corporate employees, are subject to deferred effective dates. Thus, most of the ERTA changes continue to be of great significance on an interim basis.

This Article provides a detailed, analytical outline of the ERTA changes and their effects. The changes made by the 1982 Tax Equity Act are also discussed to the extent they affect the revisions made by ERTA.

I. RETIREMENT SAVINGS PROVISIONS

A. *Individual Retirement Account (IRA),⁴ Annuity, or Bond Changes (other than for Simplified Employee Pension Plans)*

1. *Deductible Limits Raised for IRAs*

Prior to ERTA, section 219 of the Internal Revenue Code (Code) allowed a maximum deduction for a regular (non-spousal) IRA for a taxable year of the lesser of (1) \$1,500 or (2) 15% of the

3. Employee Retirement Income Security Act of 1974, Pub. L. No. 93-406, 88 Stat. 829 (codified in titles of sections 5, 18, 26, 29, 31, 42 U.S.C.) [hereinafter cited as ERISA].

4. As used in this Article, "IRA" refers to individual retirement accounts, annuities, and bonds.

applicable individual's compensation⁵ for such year.⁶ ERTA section 311(a) amends section 219 by increasing the deductible limit on a contribution to a regular IRA for a taxable year to the lesser of (1) \$2,000 or (2) 100% of the applicable individual's compensation for such year.⁷ This increase is effective for taxable years beginning after December 31, 1981.⁸

The effect of this change may be illustrated by two examples. Assume A receives \$50,000 in compensation in both 1981 and 1982 and is otherwise eligible to make deductible contributions to a regular IRA. In 1981, A can make a deductible contribution to a regular IRA of up to \$1,500. In 1982, however, because of ERTA, A can make a \$2,000 deductible contribution. Now assume that B earns only \$5,000 in compensation in both 1981 and 1982. In 1981, B could contribute and deduct up to \$750 to a regular IRA (the lesser of \$1,500 or 15% of \$5,000). In 1982, however, B can contribute and deduct up to \$2,000 to a regular IRA (the lesser of \$2,000 or 100% of \$5,000).⁹

Deductible limits have also been increased for "spousal IRAs." Where an individual receives taxable compensation in a taxable year, but the spouse of such individual does not, the individual may contribute for that year to separate IRAs established for both the individual and his or her spouse.¹⁰ Prior to ERTA, the deductible limit on contributions to both spousal IRAs, in the aggregate, for one taxable year was the least of: (1) twice the lesser of the contribution to the individual's IRA or the contribution to the spouse's IRA; (2) 15% of the individual's compensation

5. Note that, both before and after ERTA, "compensation" includes "earned income" for self-employed individuals. See I.R.C. § 219(c)(1), (f)(1) (West Supp. 1982). Only earned compensation is counted, and then only so much as is includible in gross income. Rents and royalties would not be included. See *id.* § 219(b)(1)(B). The proposed Technical Corrections Act of 1982, H.R. 6056, as passed by the House on September 14, 1982, 97th Cong. 2d Sess., 128 CONG. REC. H 6948-57 (daily ed. Sept. 14, 1982), and in amended fashion by the Senate on September 30, 1982, 128 CONG. REC. S 12,732-39 (daily ed. Sept. 30, 1982) would make clear that "earned income" of self-employed persons for this purpose is reduced by contributions to a tax qualified profit sharing or pension plan deductible under I.R.C. § 404.

6. I.R.C. § 219(b)(1) (1976).

7. I.R.C. § 219(b)(1) (West Supp. 1982).

8. ERTA § 311(i)(1).

9. The second example illustrates the incentive that ERTA provides to pay for the services performed by the spouse of the owner of a closely-held business (especially by reason of the new "100% of compensation limit"). Of course, compensation must remain "reasonable" in order to be deductible. I.R.C. § 162(a)(1) (1976).

10. I.R.C. § 219(c)(1)(B) (West Supp. 1982).

for such year; or (3) \$1,750.¹¹ These limits meant that to obtain the largest possible deductible contribution, a contribution had to be split equally between the two spousal IRAs.

ERTA section 311(a), in amending Code section 219, increases the deductible limit for spousal IRAs in a taxable year, in the aggregate, to the lesser of (1) \$2,250 or (2) 100% of the contributing individual's compensation for the year.¹² Moreover, the method of splitting the aggregate contribution between the two spousal IRAs is left to the individual and the spouse, provided that neither spousal IRA receives a contribution for one taxable year in excess of \$2,000.¹³ These provisions will now be contained in Code section 219.¹⁴

The following examples will help to explain the new spousal IRA rules. Assume that in both 1981 and 1982, A receives \$50,000 in compensation, and A's spouse, X, receives no compensation. A is otherwise eligible to make deductible contributions to spousal IRAs for A and X. For 1981, the maximum deductible contribution A could make was \$1,750, and then only if such contribution was split equally between A's and X's IRAs, with \$875 going to each account. For 1982, the maximum deductible contribution A can make is \$2,250. Such amount may be split between the two accounts in any manner, provided that neither IRA receives more than \$2,000. Assume that, in both 1981 and 1982, B receives \$5,000 in compensation and B's spouse, Y, receives no compensation. Again, B is otherwise eligible to make deductible contributions to spousal IRAs for B and Y. For 1981, the maximum deductible contribution B could make was \$750 (the lesser of \$1,750 or 15% of \$5,000), and then only if such contribution was split equally between B's and Y's IRAs, with \$375 going to each account. For 1982, the maximum deductible contribution B can make is \$2,250 (the lesser of \$2,250 or 100% of \$5,000), split in any manner, provided that neither IRA receives more than \$2,000.

2. *Active Participant Rule Eliminated for IRAs*

Prior to ERTA, if an individual for any part of a taxable year was an active participant in an employer-maintained tax qualified profit sharing, stock bonus, pension, annuity, or bond purchase

11. I.R.C. § 220(b)(1) (1976 & Supp. IV 1980).

12. I.R.C. § 219(c)(2) (West Supp. 1982).

13. *Id.*

14. I.R.C. § 220 (Supp. IV 1980), which contained the previous maximum deductible limits, is repealed by ERTA § 311(e).

plan, or tax-sheltered annuity, such individual could not make a deductible contribution to an IRA.¹⁵ ERTA section 311(a), in amending Code section 219, eliminated this restriction. Active participants in such qualified plans can, under ERTA, contribute to regular (or, where applicable, spousal) IRAs, and deduct such contributions from income in determining federal income tax (subject to the deductible limits noted above and other deduction requirements specified under Code section 219). This elimination of the "active participant" rule is effective for taxable years beginning after December 31, 1981.¹⁶

This change in the law has already resulted in a new and intense marketing effort by banks and thrift institutions, insurance companies, and brokerage firms to market individual retirement accounts and annuities to employees through their employers. In essence, employers are asked for access to their employees in order to publicize the IRA program offered. The program is designed to allow employees to make contributions through payroll deductions by their employers (in many cases with the employers picking up the administrative costs involved). As will be discussed in detail below, this IRA marketing approach is an alternative to an employer allowing deductible employee contributions to be made to the employer's own tax qualified profit sharing, stock bonus or pension plan.

One important issue which arises from the establishment of such an IRA deduction program is whether such program will be considered an employee benefit plan sponsored by the employer so as to be subject to ERISA, particularly the reporting requirements (such as annual and summary annual reports).¹⁷ In this regard, Department of Labor Regulation section 2510.3-2(d)¹⁸ notes that an IRA program will not be considered an employee benefit plan of an employer if (1) no contributions are made by the employer, (2) participation is completely voluntary for employees, (3) the employer receives no consideration in the form of cash or otherwise, other than reasonable compensation for services actually rendered in connection with payroll deductions, and (4) the sole involvement of the employer is "without endorsement" to permit the sponsor to publicize the program to employees, to col-

15. I.R.C. §§ 219(b)(2), 220(b)(3) (1976).

16. ERTA § 311(i)(1).

17. ERISA §§ 101-11, 29 U.S.C. §§ 1021-31 (1976); *id.* §§ 401-14, 29 U.S.C. 1101-14 (1976).

18. 29 C.F.R. § 2510.3-2 (1981).

lect contributions through payroll deductions, and to remit those contributions to the sponsor. An important question which arose in the past was whether the employer had indirectly "endorsed" an IRA program of a certain organization if it restricted the number of programs which could be offered to employees through payroll deduction. Such restriction was generally a necessity since, for administrative reasons, an employer cannot permit an unlimited number of organizations to offer IRAs through payroll deductions to employees.

To provide guidance in this area, the Department of Labor issued two advisory opinions which exempt certain payroll deduction IRA programs from being treated as pension plans for ERISA purposes, even if only one such IRA program is offered.¹⁹ The first opinion, issued in December, 1981, applies to employer-offered payroll deduction IRA programs which are not concurrently sponsored by the employer. Such programs will not be considered ERISA plans if four conditions are met: (1) material distributed to employees must state clearly in understandable language that the program is completely voluntary, that the employer is not endorsing either the IRA sponsor or funding media, that other funding media are available outside the payroll deduction program, that an IRA may not be appropriate for all individuals, and that the tax consequences to the employee contributing to an IRA are the same regardless of whether payroll deductions are used; (2) the employer may not be the IRA sponsor or an affiliate of the sponsor; (3) the employer may not identify the funding media's purpose as investing in employer securities, and such media may not have significant investments in such securities; and (4) if the payroll program is the result of an agreement between an employer and an employee organization, the funding media neither may be identified to employees as investing in vehicles designed to benefit an employee organization by providing jobs for its members, loaning funds to its members, or making available similar direct benefits, nor may the funding media maintain significant investments in such vehicles. The opinion further notes that all employee contributions collected by the employer must be promptly transferred to the IRA sponsor and that the employer must not exercise any influence over that sponsor; otherwise the employer will be deemed to have received additional considera-

19. Opinion Letter 81-80A, [1981] 4 PENS. & PROFIT SHARING (P-H) ¶ 120,150, Advisory Opinion 82 13A, *id.* ¶ 120,152.

tion for the IRA program, thereby making the program an employee benefit plan of the employer subject to ERISA.

The second opinion, issued in February, 1982, applies to employer-offered payroll deduction IRA programs which are concurrently sponsored by the employer. Such programs will not be considered ERISA plans if the first and fourth conditions set forth immediately above for a non-IRA-sponsor are met, and, further if (1) the IRA program offered to employees through the payroll deduction method is identical to an IRA plan offered to the general public by the IRA sponsor in the normal course of its business and (2) any management fees, sales commissions, and the like charged by the IRA sponsor with respect to the IRA program offered to its or its affiliates' employees are the same as those charged by the IRA sponsor with respect to payroll deduction IRA programs entered into by nonaffiliated employers. This second opinion, like the first, similarly mandates that all employee contributions must be transferred promptly from the IRA sponsor's general assets to the IRA program.

3. *Additional Spousal IRA Change—Joint Return Required*

ERTA section 311(a), in amending Code section 219, adds a new requirement for those eligible for "spousal IRAs." Before an individual may make a deductible contribution to an IRA established for a nonearning spouse in a taxable year, a joint return must be filed by the individual and his or her spouse for such year.²⁰ This new requirement is effective for taxable years beginning after December 31, 1981.²¹

4. *Divorced Spouse Relief*

ERTA section 311(a) creates a special contribution rule when an individual who has previously made deductible contributions to his or her spouse's IRA divorces or separates from the spouse. This rule is designed to assist the previously nonearning spouse who may, in the future, still have little or no compensation from which to continue making deductible contributions which may accumulate tax free until retirement age. Specifically, the new special rule is applicable when (1) an individual has made deductible contributions to his or her spouse's IRA for at least three of the five taxable years immediately preceding the taxable year in

20. I.R.C. § 219(c)(1)(A) (West Supp. 1982).

21. ERTA § 311(i)(1).

which a decree of divorce or separate maintenance is issued and (2) the spouse's IRA was established at least five years before the calendar year in which such decree is issued.²²

If applicable, the special rule provides that the spouse may, if otherwise eligible, make deductible contributions to the IRA for the taxable year in which the decree is issued or any later taxable year up to the lesser of (1) \$1,125 or (2) 100% of the sum of the spouse's compensation for such year and alimony received for that year (which is includable in income for purposes of determining federal income tax).²³ It should also be noted, however, that if a spouse who is eligible for the special rule has compensation (disregarding alimony) for any applicable taxable year in excess of \$1,125, the spouse can make deductible contributions up to the regular IRA deductible limits (the lesser of \$2,000 or 100% of compensation). The special rule for divorced spouses is effective for taxable years beginning after December 31, 1981.²⁴

5. *Reduction for Qualified Voluntary Employee Contributions*

As is discussed below, an individual may now be able to make deductible voluntary contributions to an employer-maintained tax qualified profit sharing, stock bonus, pension, annuity or bond purchase plan, or simplified employee pension plan, or under a Code section 403(b) annuity for taxable years beginning after December 31, 1981.²⁵ If an individual makes voluntary contributions which are eligible for deduction to a qualified plan with respect to a taxable year, ERTA section 311(a), in amending Code section 219, provides that the maximum deductible limit with respect to the year for the individual's contribution to his or her own IRA (whether that is the only IRA or one of two spousal IRAs to which he or she makes contributions) will be correspondingly reduced.²⁶

The following examples will help to explain the rule. Assume that, in 1982, A, who is eligible to make deductible voluntary contributions to his or her employer's qualified profit sharing plan and earns \$10,000, makes such a contribution in the amount of \$1,000. A may make a deductible contribution to a regular IRA for 1982 in any amount up to \$1,000 (the lesser of \$2,000 or 100% of \$10,000, less \$1,000). If A had made \$2,000 in deductible vol-

22. I.R.C. § 219(b)(4)(C) (West Supp. 1982).

23. *Id.* § 219(b)(4)(A), (b)(4)(B).

24. ERTA § 311(i)(1).

25. *See infra* notes 29-55 and accompanying text.

26. I.R.C. § 219(b)(3) (West Supp. 1982).

untary contributions to such profit sharing plan, he or she could not make a deductible contribution to a regular IRA for 1982 since his or her deductible limit would have been exhausted. Alternatively, assume that, in 1982, B is eligible to and makes deductible voluntary contributions of \$1,000 to his or her employer's qualified profit sharing plan. B earns for that year \$8,000 and is eligible to make deductible contributions to spousal IRAs for B and B's spouse, Y. The maximum deductible contribution B can make to such spousal IRAs, in the aggregate, is \$1,250 (the lesser of \$2,250 or 100% of \$8,000, less \$1,000), and the contribution can be split in any manner provided that Y's IRA receives at least \$250. Otherwise, B's IRA would have received more than the maximum limit permitted for his or her IRA. As noted before, the most any IRA (even a spousal IRA) is allowed to receive from contributions for one taxable year is \$2,000. For B's IRA, the maximum for 1982 is, thus, \$1,000 (\$2,000 less \$1,000 of deductible voluntary contributions to the profit sharing plan). If B had made \$2,000 in deductible voluntary contributions to such profit sharing plan, B could contribute \$250 to Y's IRA but could contribute nothing to B's own IRA.

6. *Other Deduction Requirements Remain Unchanged*

Except as otherwise explained, requirements for making deductible contributions to IRAs (either regular or spousal) are not changed by ERTA. For example, it continues to be true that no deductible contributions can be made for a taxable year to an IRA of an individual (or an IRA of his or her spouse) if such individual (or such spouse) has attained age seventy and one-half by the close of the year.²⁷ Furthermore, in order to be deductible for a taxable year, contributions to an IRA still must be made by the time (including extensions) for filing the contributor's federal income tax return for such year.²⁸

27. I.R.C. §§ 219(b)(3), 220(b)(4) (1976 & Supp. IV 1980); I.R.C. § 219(d)(1) (West Supp. 1982). The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would confirm that an earning spouse, even if age 70½, may make a deductible contribution to a "spousal IRA" for the nonearning spouse if the nonearning spouse has not attained age 70½ in the taxable year of contribution.

28. I.R.C. §§ 219(c)(3), 220(c)(4) (Supp. IV 1980); I.R.C. § 219(f)(3)(A) (West Supp. 1982).

B. *Deductible Employee Contributions to Qualified Plans*

1. *General*

ERTA section 311(a), in amending Code section 219, allows an individual, who is otherwise eligible to make deductible contributions to a regular IRA, to deduct certain contributions made to a qualified profit sharing, stock bonus, or pension plan established under Code section 401(a), a qualified annuity plan established under Code section 403(a), a qualified bond purchase plan established under Code section 405(a), a simplified employee pension plan established under Code section 408(k), a tax-sheltered annuity established under Code section 403(b) or a government plan maintained for government employees.²⁹ Deductible employee contributions to such plans are subject to the rules specified below. Deductible employee contributions may not be made to a plan (except for a government plan) for any year the plan is not tax-qualified.³⁰ Provisions concerning deductible employee contributions to eligible plans are effective for taxable years beginning after December 31, 1981.³¹

2. *Employee Contributions Eligible for Deduction*

Not all employee³² contributions are eligible for deduction under the new legislation. ERTA provides that employee contributions are not eligible for deduction unless the applicable plan permits such contributions.³³ A plan which does not currently provide for any voluntary employee contributions must, therefore, be amended in order for it to allow deductible employee contributions.³⁴ Under ERISA, it is unclear whether a plan that already permits employee contributions must be specifically amended to

29. I.R.C. §§ 219(a), (e)(1)(A), (e)(2)(A)(i), (e)(3), (e)(4) (West Supp. 1982). A qualified profit sharing, stock bonus or pension plan eligible to receive deductible employee contributions includes Keogh plans (i.e., plans benefiting at least some self-employed persons). See IRS Notice 82-13 (Q. and A. II-1), 1982-19 I.R.B. 15.

30. See IRS Notice 82-13 (Q. and A. I-22), 1982-19 I.R.B. 15.

31. ERTA § 311(i)(1).

32. To be eligible for deduction, the contributions must be made by an individual as an "employee." I.R.C. § 219(e)(2)(A)(i) (West Supp. 1982). Although not expressly stated, it appears that for this purpose, this term includes self-employed persons. The principal indication that self-employed individuals are to be considered "employees" is the provision in *id.* § 219(f)(1), that the term "compensation" includes earned income as defined in I.R.C. § 401(c)(2) (1976). This, however, is by no means conclusive.

33. I.R.C. § 219(e)(2)(A)(i) (West Supp. 1982).

34. IRS Notice 82-3, 1982-9 I.R.B. 12; IRS Notice 82-13 (Q. and A. I-2), 1982-19 I.R.B. 15.

allow for deductible contributions, or whether a manifestation of consent is sufficient. The Internal Revenue Service (IRS) recently issued notices indicating that an amendment is not necessary and that a manifestation of consent is sufficient to allow for deductible contributions.³⁵ The notices state, for example, that an employer could inform plan participants that the plan will accept deductible contributions, and the employer may describe to participants the notice used to designate contributions as deductible. The IRS notices also indicate that separate accounting for deductible and nondeductible employee contributions, if both are allowed under the plan, should be established to prevent reporting penalties to the plan administrator or adverse tax consequences to the contributing employees. Final IRS regulations are still necessary, however, to answer conclusively this question.³⁶

Conversely, it would appear consistent with the statute that a plan which already permits employee contributions need do nothing to retain its current method of handling such contributions if nondeductibility is desired. In other words, without an amendment or some manifestation of consent, employee contributions should not become deductible, and no specific amendment should be required to prevent deductibility. The IRS has confirmed this view in its recent notices,³⁷ although, again, final IRS regulations are necessary. In both cases, it might be advisable to amend the plan to note explicitly that deductible employee contributions are or are not allowed.³⁸

In addition to requiring a plan provision allowing employee contributions to be eligible for deduction, the employee contributions must also be "voluntary."³⁹ A voluntary contribution is one which is not a condition of employment, a condition of plan participation, or a condition of obtaining benefits from employer contributions (such as being matched to any degree by employer contributions).⁴⁰ To illustrate the latter requirement, assume that

35. *Id.*

36. Support for the position taken in IRS Notices 82-3 and 82-13 is provided, however, by the STAFF OF THE JOINT COMM. ON TAXATION, 97th Cong., 1st Sess., GENERAL EXPLANATION OF THE ECONOMIC RECOVERY TAX ACT OF 1981, at 201 (Comm. Print. 1981) [hereinafter cited as STAFF EXPLANATION].

37. IRS Notice 82-3, 1982-9 I.R.B. 12; IRS Notice 82-13, 1982-19 I.R.B. 15.

38. Whatever the intent of Congress was, the special restriction imposed upon such deductible contributions once in the plan would indicate the need for provisions to protect the plan and participants. The deduction issue should be treated in that amendment.

39. I.R.C. § 219(e)(1)(A), (e)(2)(B) (West Supp. 1982).

40. I.R.C. § 411(c)(2)(C) (1976).

a plan allows each covered employee to make, at his or her discretion, contributions of 1%, 2%, 3%, 4% or 5% of such employee's compensation. The employer maintaining the plan also contributes an amount on behalf of each contributing employee equal to 50% of the contributions made by the employee. None of the employee contributions is "voluntary" so as to be eligible for deduction because of this "matching" feature of employer contributions, despite the fact that an employee is not required to contribute any amount above 1% of his or her compensation in order to participate in the plan.⁴¹

An employee making a "voluntary" contribution also may not designate the contribution for anything but the intended deduction.⁴² A designation that contributions are not intended to be deducted must be made by April 15 following the close of the calendar year in which the contribution is made, or any earlier date designated by the plan administrator.⁴³ The contributions themselves, however, need not be made until April 15 unless the plan administrator specifies an earlier date.

Although the April 15 date is allowable for designation, an administrator of a plan which permits both deductible and nondeductible contributions might prefer to specify an earlier designation date. It is probable that separate bookkeeping accounts will be necessary under the plan to account for deductible employee contributions and net earnings and income thereon.⁴⁴ If such a separate "deductible employee contribution account" is established, the plan administrator should, in most cases, require an employee to make a designation as to the nondeductibility of his or her voluntary contributions no later than the next date on which the plan's trust funds are valued. A designation made on a later date would give the plan administrator the difficult and very expensive task of reallocating plan income and earnings between deductible and nondeductible employee contribution accounts. For this reason, some plan administrators may require an irrevocable designation as contributions are made. Such administrators may permit either deductible or nondeductible contributions, but not both.⁴⁵ A designation that employee contributions are not intended to be deductible is to be made in such manner as the IRS

41. Rev. Rul. 81-234, 1981-41 I.R.B. 7.

42. I.R.C. § 219(e)(2)(A)(ii) (West Supp. 1982).

43. *Id.* § 219(e)(2)(C).

44. See *infra* notes 68-73 and accompanying text.

45. IRS Notice 82-13 (Q. and A. I-6), 1982-19 I.R.B. 15, allows a plan administrator

prescribes.⁴⁶

3. *Deduction Rules*

Employee contributions to qualified plans, which contributions satisfy the requirements of Code section 219, as amended by ERTA section 311(a), are known as "qualified voluntary employee contributions" (QVECs)⁴⁷ and, as such, generally are deductible from gross income. These deductions, in arriving at adjusted gross income, are subject to essentially the same rules as apply to deductible contributions to a regular IRA.⁴⁸ For QVECs to be deductible in a given taxable year, therefore, the applicable employee cannot be age seventy and one-half or older by the end of such year.⁴⁹ However, the IRA contributor is only required to make such contributions at some time before filing his or her federal income tax return for such year. The QVECs must be made by April 15 (or an earlier date as designated by the plan administrator) following the calendar year for which the contribution is intended.⁵⁰ This raises the question of whether a plan established or amended to accept QVECs, after the close of a calendar year, but before the following April 15, may receive employee contributions deductible for the just-ended calendar year. Literally read, ERTA provides no reason to prohibit this result. Deductible limits for one year are the same as for a regular IRA—that is, the lesser of (1) \$2,000 or (2) 100% of compensation for that year.⁵¹ However, an employee may not make QVECs on behalf of his or her spouse, even if otherwise eligible to do so under the "spousal IRA" rules. The statute clarifies this point by limiting "spousal IRA" deductions to amounts contributed to an "individual retirement plan."⁵²

to require an irrevocable designation of the type of voluntary contributions before such contributions are made.

46. I.R.C. § 219(e)(2)(C)(ii) (West Supp. 1982).

47. The term "Qualified Voluntary Employee Contributions" (QVECs) will refer to employee contributions which are (1) made to an eligible plan permitting this type of contribution, (2) "voluntary," and (3) not designated by the employee as being intended other than as deductible (in accordance with proper procedures therefor), regardless of whether for other reasons no deduction is actually taken, or even available, by reason of such contributions.

48. I.R.C. § 62(10) (1976).

49. I.R.C. § 219(d)(1) (West Supp. 1982).

50. *Id.* § 219(f)(3).

51. *Id.* § 219(b), (a), (e)(1)(A).

52. *Id.* § 219(c)(1). The term "individual retirement plan" is defined in I.R.C. § 7701(a)(37) (Supp. IV 1980) as an individual retirement account, annuity, or bond. *See also* IRS Notice 82-13 (Q. and A. I-13), 1982-19 I.R.B. 15.

An employee may make a QVEC from an amount previously distributed to the employee from the plan, even if such prior distribution represented the return of nondeductible contributions to the plan.⁵³ Tax will be due on the prior distribution to the extent it represents earnings which have not previously been taxed.⁵⁴

Any QVECs will correspondingly reduce the deductible contribution that can be made for that taxable year by the employee to a regular or spousal IRA; this is true regardless of whether the employee later (after the time for designating such plan contributions as nondeductible has ended) desires not to deduct such plan contributions.⁵⁵ To illustrate, assume that employee A makes QVECs of \$2000 to plan M (which permits such contributions). Plan M requires the employee, if he or she desires, to designate such contributions as other than intended for deduction, and to make such designation by December 31 (plan M's next valuation date). The following April 14, A decides that it is preferable to make a deductible contribution to a regular IRA with XYZ Bank for the taxable year which ended on the prior December 31, and to treat the plan contributions as nondeductible. Employee A may not do so since A's IRA deductible limit has been exhausted by the QVECs.

4. *Limitations on Use*

QVECs, while held in a plan, are subject to certain use restrictions similar to those imposed on IRAs. ERTA section 311(b), in amending Code section 72(o), provides that any assignment or pledge by an employee of his or her QVECs, or net earnings and income thereon, will cause the amount so assigned or pledged to be deemed distributed to him or her.⁵⁶ Similarly, distribution is deemed to have occurred if an employee is loaned funds from his or her QVECs, or net earnings and income thereon, to the extent of such loan.⁵⁷ Finally, if such contributions, or net earnings and income thereon, are used to purchase life insurance contracts, the amount so used will be deemed to have been distributed.⁵⁸

As will be discussed below, any amounts which are deemed distributed under the above rules will be taxed as ordinary income

53. IRS Notice 82-13 (Q. and A. I-10), 1982-19 I.R.B. 15.

54. *Id.*

55. See I.R.C. § 219(b)(3), (e)(2)(A), (e)(2)(C) (West Supp. 1982).

56. *Id.* § 72(o)(3)(A); I.R.C. § 72(m)(4)(A) (1976).

57. I.R.C. § 72(o)(3)(A) (West Supp. 1982).

58. *Id.* § 72(o)(3)(B).

to the employee and, if the employee has not yet attained age fifty-nine and one-half, or become disabled by the time of the "deemed" distribution, such amount will be subject to an additional tax by reason of such "premature" distribution.⁵⁹ Furthermore, a question arises as to whether such a deemed distribution from a qualified profit sharing, stock bonus, or pension plan might result in the plan's disqualification because of noncompliance. Qualified profit sharing plans and qualified stock bonus plans may distribute funds only after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of an event such as layoff, illness, disability, retirement, death, or severance of employment.⁶⁰ Qualified pension plans, on the other hand, may distribute funds only after retirement or at least attainment of retirement age.⁶¹ At issue is whether QVECs must use the same distribution rules as apply to the plan in which such contributions are held, or whether such contributions may be withdrawn at will without regard to the normal rules applicable to that plan.⁶² No conclusive answer to this question is yet available. The IRS, however, has not appeared to forbid withdrawal of employee nondeductible voluntary contributions in the past.⁶³ Moreover, even though the tax treatment of such amounts is quite different from the treatment of QVECs, the IRS appears to arrive at the same result with respect to QVECs.⁶⁴

An additional argument against disqualification is found in legislative history dealing with the issue of "collectibles" under ERTA. As also will be discussed in some detail below, ERTA section 314(b) adds Code section 408(n), which states that any acquisition of a collectible by an IRA or an individually-directed account under a qualified profit sharing, stock bonus, or pension plan will be treated as a distribution from such account in an amount equal to the cost of such collectible.⁶⁵ Legislative history indicates that a "deemed" distribution resulting from the invest-

59. See *infra* note 88 and accompanying text.

60. Treas. Reg. § 1.401-1(b)(1)(ii), (iii) 1956-2 C.B. 219.

61. Treas. Reg. § 1.401-1(b)(1)(i), 1964-1 (Part 1) C.B. 144; Rev. Rul. 56-693, 1956-2 C.B. 282; IRS Publication 778, Part 2(o), [1982] 4 PENS. & PROFIT SHARING (P-H) ¶ 107,070 (Feb. 1982).

62. See *infra* notes 113-15 and accompanying text.

63. Rev. Rul. 69-277, 1969-1 C.B. 116. As noted in the ruling, the primary concern of the Internal Revenue Service appears to be with constructive receipt of earnings on voluntary contributions.

64. IRS Notice 82-13 (Q. and A. I-14), 1982-19 I.R.B. 15.

65. See *infra* notes 347-52 and accompanying text.

ment in a collectible by an individually-directed account of a qualified profit sharing, stock bonus, or pension plan would not affect the qualified status of such plan.⁶⁶ Furthermore, Revenue Ruling 69-380⁶⁷ states that a deemed distribution to an owner-employee will be considered to affect only the owner-employee, and not the qualified status of the plan as to other participants.

5. *Plan Accounting*

ERTA and its legislative history make clear that a plan may segregate plan assets which are to be allocable to QVECs.⁶⁸ If plan assets are not segregated, however, for purposes of determining certain tax results, ERTA section 311(b), in amending Code section 72(o), specifies that it must be possible for plan earnings, losses, income, and expenses to be "allocable" to QVECs.⁶⁹ This latter allocation is achieved by establishing a specific plan bookkeeping account to which such contributions are allocated. The account is then adjusted at least annually to allow for plan earnings, losses, income, and expenses.⁷⁰ This bookkeeping account is to be separate from accounts established to record either employer contributions made on behalf of the employee, or nondeductible contributions made by the employee.⁷¹

It is possible, though unlikely, that IRS regulations will allow an "artificial" method of allocating plan earnings, etc., to QVECs, similar to the artificial method allowed in Treasury Regulation section 1.411(c)-1(b)(2) for determining that portion of an accrued benefit of a defined contribution plan which is attributable to employee contributions. Pursuant to that regulation, in circumstances in which separate accounts are not maintained, one can determine the portion of the accrued benefit (i.e., the total balance to the credit of an employee) attributable to employee contributions by multiplying the accrued benefit by a fraction, the numerator of which is the total amount of the employee's contribution less withdrawals, and the denominator of which is the total amount of all contributions less withdrawals. Whether such an artificial method will be permitted must finally be determined by

66. H.R. REP. NO. 201, 97th Cong., 1st Sess. 143 (1981).

67. Rev. Rul. 69-380, 1969-2 C.B. 97-98.

68. S. REP. NO. 144, 97th Cong., 1st Sess. 115 (1981); STAFF EXPLANATION, *supra* note 36, at 201.

69. I.R.C. § 72(o)(5)(B) (West Supp. 1982).

70. S. REP. NO. 144, 97th Cong., 1st Sess. 115 (1981); H.R. REP. NO. 201, 97th Cong., 1st Sess. 135 (1981).

71. H.R. REP. NO. 201, 97th Cong., 1st Sess. 135 (1981).

IRS regulations. The IRS recently has stated that a plan will not fail to qualify merely because it fails to account separately for QVECs.⁷² The IRS has not, however, specified an artificial method of allocating plan earnings. The IRS has noted that separate accounting may be required both to prevent adverse tax consequence to an employee receiving distributions of both deductible and nondeductible contributions from the plan, and to avoid reporting penalties imposed on the plan administrator.⁷³ Both of these rationales for separate accounting are discussed below.

Most plan administrators will probably prefer to utilize the more accurate "separate account" method. The separate account method may in some cases have an interesting and adverse effect on the income tax results of distributions of QVECs. If the separate account set-up for an employee's QVECs contains both deductible and nondeductible contributions, it may be impossible (without resort to some artificial allocation rule) to allocate plan earnings, etc., between those QVECs which were allowable as a deduction and those which were not. In this case, unless IRS regulations do allow some artificial allocation rule, the result may be that *all* taxable distributions which correspond to the accrued benefits attributable to employee contributions will be taxed in accordance with the rules for taxing distributions of QVECs which *were* allowable as a deduction. Therefore, no portion of the distributions would be eligible for the kinds of favorable tax treatment associated with qualified plan distributions. QVECs which are allowable as a deduction, and net earnings and income allocable thereto, are taxed when distributed under ordinary income rules, as are IRA distributions. QVECs which are not allowable⁷⁴ as a deduction, and net earnings and income allocable thereto, however, are to be taxed under rules which permit tax-free distribution of the prior dollar amount of employee contributions and which, as to distribution of earnings thereon, may allow "ten-year forward averaging" and special treatment of unrealized appreciation of distributed employer securities (including tax deferral at distribution and later capital gain treatment when eventually the securities are sold by the employee).⁷⁵ Again, IRS regulations

72. IRS Notice 82-13 (Q. and A. I-3), 1982-19 I.R.B. 15.

73. *Id.*

74. I.R.C. § 219(d)(1) (West Supp. 1982). *See id.* § 219(b). *See also supra* text accompanying notes 48-55.

75. *Id.* § 402(e)(4)(A), (a)(1), (e)(4)(J). Note that although not all QVECs are deducti-

must resolve this matter.

Moreover, if a "rollover"⁷⁶ of the tainted distribution is desired, the rules applicable to "allowable" QVECs are slightly more favorable to the employee than the rules for nonallowable contributions, in that the ability to rollover a distribution of "allowable" contributions is not dependent on some "triggering event" such as a plan termination, separation from service, etc.⁷⁷ In this case, unless IRS regulations allow an artificial allocation rule, the result may be that the less favorable rules for "nonallowable" QVECs will control with respect to the entire amount.⁷⁸

Plan accounting is also important for determining compliance with Code section 415. Code section 415 limits the amount of "annual addition" permitted for any plan "limitation year" with respect to any one employee under a qualified plan.⁷⁹ For purposes of determining such annual addition, QVECs which are allowable as a deduction will be disregarded.⁸⁰ QVECs which are not allowable as a deduction apparently will be considered in determining the annual addition.⁸¹ Presumably, the IRS will permit plans to use "fail safe" suspense account or refund provisions to avoid accidental disqualification. For instance, a recent IRS notice indicates that if QVECs which are not allowable as a deduction, and are not in excess of \$2,000 for a year, are, together with earnings thereon, returned to the employee as soon as administratively feasible, no disqualification will result.⁸² Unfortunately, administrators may not be in a position to know for certain whether participants have, for example, contributed to a different employer's plan, thereby rendering part of their contribution non-deductible. Ideally, these amounts would be segregated from the rest of the plan (i.e., in a QVECs account) rather than being converted to regular voluntary contributions if not deductible.

Finally, unless a plan specifies otherwise, ERTA section 311(b), in amending Code section 72(o), provides that any distri-

ble, only the deductible ones are treated as employer contributions for purposes of I.R.C. §§ 402, 403, 405 (1976 & Supp. IV 1980), pursuant to I.R.C. § 72(o)(1) (West Supp. 1982).

76. See *infra* notes 89-97 and accompanying text.

77. I.R.C. § 402(a)(5)(D)(i) (West Supp. 1982).

78. In considering the two methods, it should be noted that the "separate account" method will not affect any estate or gift tax results. The estate and gift Code sections which are applicable automatically use an artificial rule.

79. I.R.C. § 415(a)(1)(B) (1976).

80. I.R.C. § 415(c)(2) (West Supp. 1982).

81. IRS Notice 82-13 (Q. and A. I-19), 1982-19 I.R.B. 15.

82. *Id.*

bution from a qualified plan shall not be treated as being from amounts attributable to QVECs until all other amounts to the credit of the employee have been distributed.⁸³ If "rollovers" out of the plan are to be allowed to continuing participants under Code section 402(a)(5)(D), this ordering rule must be modified.⁸⁴

6. *Income Tax Rules on Distributions*

Distributions of QVECs which were allowable as a deduction, and plan net earnings and income attributable thereto, are generally taxed to the employee, or his or her beneficiary, as ordinary income.⁸⁵ The favorable tax treatment enjoyed by distributions from qualified plans,⁸⁶ such as "ten-year forward averaging," and the exclusion from immediate taxation of unrealized appreciation in the plan employer's securities, which securities are distributed and attributable to QVECs,⁸⁷ will not apply to the distributions, even when paid in a single sum. Furthermore, as with IRAs, if a general distribution to an employee occurs prior to age fifty-nine and one-half, or disability, it will be subject to an additional "premature" distribution tax equal to 10% of the amount of the distribution.⁸⁸

Legislative history⁸⁹ and certain provisions of the Code amended by ERTA,⁹⁰ indicate that QVECs which are allowable as a deduction, and plan net earnings and income allocable thereto, may be rolled over to an individual retirement plan (such as an IRA) or another qualified plan (except, if the employee is self-employed when contributions are made, rollover is permitted only to an individual retirement plan), in accordance with rollover rules of Code section 402(a)(5), as amended by ERTA section 311(b)(3). If a rollover is made by the employee, the amount distributed is not included in his or her gross income,⁹¹ and the 10% early withdrawal penalty is avoided.⁹² The amount rolled over is

83. I.R.C. § 72(o)(6) (West Supp. 1982).

84. Unless the plan modifies the ordering rule, a presumed rollover would be considered a distribution of other amounts raising questions of plan qualification under Treas. Reg. § 1.401-1(b)(1)(i), (ii), (iii), *supra* notes 60-61.

85. I.R.C. §§ 72(o), 402 (West Supp. 1982).

86. *See supra* note 75 and accompanying text.

87. I.R.C. § 402(a)(1), (e)(4)(A), (e)(4)(J) (West Supp. 1982).

88. *Id.* § 72(o)(2).

89. S. REP. NO. 144, 97th Cong., 1st Sess. 114 (1981); STAFF EXPLANATION, *supra* note 36, at 204; H.R. REP. NO. 201, 97th Cong., 1st Sess. 136 (1981).

90. *See* I.R.C. §§ 72(o)(4), 402(a)(5)(D)(i) (III) (West Supp. 1982).

91. I.R.C. § 402(a)(5)(A) (Supp. IV 1980).

92. I.R.C. § 72(o)(2) (West Supp. 1982), states that the "premature distribution" pen-

included in the employee's income only when the amount is distributed from the individual retirement plan or other qualified plan receiving the rollover. Legislative history⁹³ and provisions of the Code amended by ERTA⁹⁴ also indicate that rollovers of QVECs allowable as a deduction, and plan net earnings and income allocable thereto, are to be available for rollover on a very liberal basis. This is true whether the rollover constitutes part of the entire distribution of the balance in the plan to the credit of the employee or whether the rollover distribution is part of a distribution of all such QVECs.

Unfortunately, the spirit of the legislative history and ERTA provisions was not explicitly carried out in the statute because of an apparent drafting oversight in ERTA. Code section 402(a)(5)(A)(i) specifies that the requirement for obtaining rollover treatment of a distribution is for the "balance to the credit" of an employee to be paid to him as a "qualifying rollover distribution." Code section 402(a)(5)(D)(i)(III), which was added by ERTA section 311(b)(3)(iv), provides that a distribution of the employee's QVECs which are allowable as a deduction, and plan net earnings and income attributable thereto, constitutes a "qualifying rollover distribution." Code section 402(e)(4)(A), however, as amended by ERTA section 311(b)(2), expressly states that the "balance to the credit" of an employee does not include "allowable" QVECs and related net earnings and income for all purposes of Code section 402. In other words, with one hand ERTA appears to specify that the distribution of QVECs will be eligible for rollover since such distribution constitutes a "qualifying rollover distribution"; while with the other hand ERTA states under the literal language of the statute that QVECs cannot constitute part of the "balance to the credit" of an employee, and thereby will never be eligible for rollover distribution treatment. It is to be hoped that IRS regulations or correcting legislation will allow rollover treatment for QVECs in accordance with the spirit of the legislative history. The IRS has indicated that, to an as yet undefined extent, rollover will be permitted.⁹⁵

alty is 10% of the amount so received "to the extent that such amount is includible in gross income." Under I.R.C. § 402(a)(5)(A) (Supp. IV 1980), an amount effectively rolled over is *not* included in gross income.

93. See *supra* note 89.

94. See *supra* note 90.

95. IRS Notice 82-13 (Q. and A. I-24), 1982-19 I.R.B. 15. In addition, the proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), if enacted, would make

The literal language of ERTA provides that failure to distribute QVECs will not disqualify an otherwise valid rollover of other amounts. A non-distribution of contributions will rarely occur in actual practice, however, because most amounts to the credit of an employee (other than employee money) are paid upon termination of employment. A plan administrator only rarely would keep an employee's money after the employee's termination or after the payment of all other amounts to the credit of the employee.

Assuming rollover is permitted for QVECs, if such contributions, and earnings and income attributable thereto, are rolled over to an individual retirement plan (such as an IRA), under the normal rules of Code section 402(a)(5) the amount may be "re-rolled over" to another employer qualified plan accepting the rollover if the following requirements are met: (1) the entire amount in the individual retirement plan is rolled over and is attributable solely to a prior rollover from an employer qualified plan; (2) the re-rollover is made within 60 days of the individual retirement plan distribution; and (3) the amount is not attributable to contributions made by the employee as a self-employed person.⁹⁶

ERTA section 311(b)(1) provides, in adding Code section 72(o)(4), that IRS regulations will prescribe rules so that QVECs which are re-rolled over to a new employer's qualified plan will remain subject to the tax rules applicable to QVECs and will not gain special tax benefits associated with other amounts held by qualified plans.⁹⁷

All of the tax results described above apply to QVECs which are allowable as a deduction from gross income, and to plan net earnings and income allocable thereto. It does not matter if an employee fails to take a deduction, so long as contributions are allowable as a deduction.⁹⁸

clear that rollovers of QVECs are allowed regardless of whether the rollover is part of an entire distribution of a plan account.

96. I.R.C. §§ 402(a)(5)(E)(i), 408(d)(3) (Supp. IV 1980). Provisions of the Tax Equity Act, which eliminate most differences between corporate and self-employed plans, may cause later legislation to eliminate the rule that a "re-rollover" cannot be made from a self-employed plan to a corporate plan.

97. The primary concern of Congress is the avoidance of a situation in which an employee was allowed a deduction for a contribution and then, through a series of rollovers, was able to obtain ten year forward averaging treatment on the final distribution. Before ERTA, this risk was controlled simply by prohibiting rollovers from IRAs into qualified plans except for amounts originally arising from qualified plans. *See id.* § 408(d)(3).

98. I.R.C. § 72(o)(5)(A) (West Supp. 1982). *But see supra* notes 70-77 and accompanying text. Separate problems exist where a separate account method is used to record

7. Estate and Gift Tax Rules on Distribution

Code section 2039(c) and (f) states that annuities and other payments not qualifying as "lump sum distributions" under Code section 402(e)(4) made from a tax-qualified profit sharing, stock bonus, or pension plan established under Code section 401(a), or an annuity plan established under Code section 403(a), which payments are receivable by any beneficiary (other than the executor) of a deceased employee, will be excluded from the decedent's gross estate for purposes of determining federal estate tax. The 1982 Tax Equity Act limits this exclusion to \$100,000 for decedents dying after 1982.⁹⁹ Code section 2039(c) provides further, however, that the exclusion does not apply to the extent such "non-lump sum distribution" payments are attributable to employee contributions. That portion of the payments not excluded from the estate is determined by multiplying the value of the annuities or payments by a fraction, the numerator of which is the total employee contributions to the plan, and the denominator of which is the total contributions to the plan.¹⁰⁰

For this purpose, ERTA section 311(d), in amending Code section 2039, provides that QVECs which were allowable as a deduction from income in determining federal income tax will be considered as contributions to a plan made by a person other than the deceased employee.¹⁰¹ As a result, allowable QVECs will not be included in a deceased employee's gross estate, unless they are paid in one taxable year and qualify as a lump sum distribution.¹⁰² This raises a question as to whether this amount can be paid as a lump sum in light of Code section 402(e)(4)(A), which provides that such amounts are not to be considered part of the "balance to the credit" of the employee. An argument can be made that QVECs will never be included in the gross estate of the employee.¹⁰³ This result would be consistent with estate tax results for other nonemployee-paid amounts held in the plan for the employee, which are not included (to the extent permitted by law) in the gross estate generally if an irrevocable election is made by the

QVECs and where such contributions are not "allowable" for deduction because, for example, the employee has attained age 70½ in the taxable year of the contribution or the exceeding of deductible limits.

99. Tax Equity Act § 245.

100. I.R.C. § 2039(c) (1976 & Supp. IV 1980).

101. I.R.C. § 2039(c) (West Supp. 1982).

102. *Id.* § 402(e)(4)(A).

103. *But see infra* notes 337-41 and accompanying text. QVECs may be included in the gross estate of the employee if they are in the constructive receipt of the employee.

beneficiary (other than the executor) to forego favorable income tax treatment.¹⁰⁴ QVECs, as already discussed, cannot qualify for such favorable treatment.¹⁰⁵ Thus, non-includibility in the estate (to the extent permitted by law) would appear consistent with such income tax result.¹⁰⁶

The rules concerning exclusion from the gross estate for amounts paid from IRAs and amounts derived from "allowable" QVECs are not identical. In general, amounts paid from an IRA are excluded from the gross estate of the IRA owner only if such amounts are paid in substantially equal periodic payments over at least thirty-six months.¹⁰⁷ Allowable QVECs unquestionably will be excluded from the gross estate if paid over two taxable years, and may be so excluded even if paid in one taxable year.¹⁰⁸ In both cases, beginning with deaths after 1982, the 1982 Tax Equity Act will only allow up to a \$100,000 exclusion from the gross estate.¹⁰⁹

ERTA provides comparable federal gift tax relief for amounts paid from IRAs and amounts derived from "allowable" QVECs. Code section 2517 provides that an employee's exercise or nonexercise of an option, whereby an annuity or other payment from a qualified employer profit sharing, stock bonus, pension plan or an annuity plan will be payable to a beneficiary at the employee's death, will not be subject to gift tax, except to the extent the payments are attributable to the employee's own contributions.¹¹⁰ ERTA section 311(d) amends Code section 2517 (as it does Code section 2039) to provide that QVECs which were allowable as a deduction from income in determining federal income tax will be considered as contributions to a plan made by a person other than the employee.¹¹¹ As a result, allowable QVECs will generally not be subject to gift tax.¹¹²

104. I.R.C. § 2039(c), (f) (1976 & Supp. IV 1980).

105. See *supra* notes 85-88 and accompanying text.

106. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), however, could be read to prohibit an estate tax exclusion for QVECs unless distributed with other amounts to the credit of an employee qualifying as a "lump sum distribution."

107. I.R.C. § 2039(e) (Supp. IV 1980).

108. See *supra* note 102 and accompanying text.

109. Tax Equity Act § 245.

110. This is similarly determined under I.R.C. § 2039 (1976 & Supp. IV 1980).

111. I.R.C. § 2517(b) (West Supp. 1982).

112. Note that this rule already applies to IRAs pursuant to the first sentence of I.R.C. § 2517(b) (1976). Later legislation may conform the gift tax area to the new "\$100,000 limit" on exclusion from gross estates after 1982. See *supra* note 99 and accompanying text.

8. Plan Distribution Rules

Apart from the special income tax rules just discussed, the language of ERTA implies that distributions of QVECs will be subject to the distribution rules applicable to the eligible plan in which such contributions will be held.¹¹³ It is unclear, however, whether this is, or should be, the intended construction of the statute; another explanation of the law would hold that QVECs may be withdrawn, as with savings accounts, at will. In the context of nondeductible voluntary employee contributions, the issue of whether contributions should be subject to plan distribution rules has similarly arisen. In general, the IRS has not demanded that nondeductible voluntary employee contributions be subject to the general distribution rules of the plan in which they are held.¹¹⁴ The IRS has recently expressly stated that the distribution restrictions for profit sharing, stock bonus, and pension plans, noted above, will not apply to distributions of QVECs.¹¹⁵

A planning consideration is that distributions of QVECs are *not* subject to the "IRA rule": the rule requiring that distribution must be made, or at least begin, by the close of the taxable year in which the employee attains age seventy and one-half.¹¹⁶ However, QVECs will likely be subject to the "qualified plans" rule that normal distributions must not, in effect, create survivorship protections which are more than "incidental" to the basic distributions.¹¹⁷ Also, the distribution of QVECs is, in general, subject to a "premature" distribution tax added to the ordinary tax on distribution.¹¹⁸ As with IRAs, the distribution to an employee is premature if it is made prior to age fifty-nine and one-half or

113. For the rules governing distribution from qualified plans see *supra* notes 60-61 and accompanying text.

114. Rev. Rul. 69-277, 1969-1 C.B. 116.

115. IRS Notice 82-13 (Q. and A. I-14), 1982-19 I.R.B. 15.

116. I.R.C. § 72(o)(5) (West Supp. 1982), does not contain a provision comparable to the age 70½ rule found in I.R.C. § 408(a)(6) (1976).

117. Distributions deferred far enough into the future obviously become death benefits, and death benefits must be incidental to the basic retirement income purpose of the program. See Treas. Reg. § 1.401-1(b)(1)(i), 1964-1 (Part 1) C.B. 144. But see IRS Notice 82-13 (Q. and A. I-14), 1982-19 I.R.B. 15, which states that the distribution restrictions of such Treasury Regulations will not apply to distributions of QVECs (although it is unclear whether the "incidental" restriction is for this purpose a *distribution* restriction inapplicable to QVECs). The Tax Equity Act § 242 provides, effective after 1983, that distributions from all plans cannot be delayed past age 70½ or, for certain non-key employees, retirement.

118. See *supra* note 88 and accompanying text.

disability.¹¹⁹

9. *Effect on Lump Sum Distribution*

Code sections 402(a)(2) and (e) permit special tax treatment for certain lump sum distributions from employer plans qualified under Code section 401(a). To obtain this special treatment, including ten-year forward averaging, the entire balance in the plan to the credit of the employee must be distributed.¹²⁰ For this purpose, pursuant to ERTA section 311(b), in amending Code section 402(e)(4)(A), any QVECs which were allowable as a deduction from gross income, and plan net earnings and income allocable thereto, may be disregarded. Thus, a lump sum distribution of the other amounts in the plan allocable to an employee may be eligible for favorable tax treatment regardless of whether the "allowable" QVECs are distributed at the same time. A significant problem could arise, however, as noted above, if (1) a separate account for QVECs is established and (2) both contributions which are allowable as a deduction and those which are not are allocated to such account. If these two situations exist, the entire QVECs account may be tainted and will have to be distributed with the other plan amounts due an employee in order for lump sum distribution tax treatment to apply to any portion of the plan distribution.¹²¹ This provision also has a confusing impact on the rollover rules found in Code section 402(a)(5).¹²² IRS regulations are necessary to clarify this area.

10. *Discrimination and General Voluntary Contribution Limit*

The legislative history of ERTA indicates that the ability to make QVECs must be available on a nondiscriminatory basis both for (1) the total of QVECs and nondeductible employee contributions and (2) QVECs alone.¹²³ It remains ambiguous, how-

119. I.R.C. § 72(o)(2) (West Supp. 1982).

120. I.R.C. § 402(e)(4)(A), (e)(4)(C) (1976).

121. See *supra* notes 72-75 and accompanying text.

122. See *supra* notes 76-78 and accompanying text.

123. S. REP. NO. 144, 97th Cong., 1st Sess. 114 (1981); H.R. REP. NO. 201, 97th Cong., 1st Sess. 135 (1981). The IRS, in Notice 82-13, 1982-19 I.R.B. 15, has stated (in Q. and A. I-16) that it views a nondiscriminatory group of employees as one which either meets the percentage requirements of I.R.C. § 410(b)(1)(A) (1976) or comprises a classification of employees that does not discriminate in favor of employees who are officers, shareholders or highly compensated as provided in *id.* § 410(b)(1)(B). Further, the same Notice (in Q. and A. I-16) provides that, if a plan requires that certain standards (such as receiving compensation above a specific integration level or making a certain level of mandatory contributions) be met in order to be allowed to make QVECs, those persons who meet such

ever, whether QVECs are applied against the "10%-safe harbor" rule provided for in Revenue Ruling 80-350,¹²⁴ as modified in Revenue Ruling 81-234,¹²⁵ for normal voluntary employee contributions. Under this rule, an employee is allowed to make discretionary contributions, not matched by employer contributions, to all of his or her employer's qualified plans up to an aggregate amount equal to 10% of the employee's compensation during the period of plan participation.¹²⁶ The reason for the limit is to prevent an unreasonable tax-free buildup of employee monies. Recently published IRS notices¹²⁷ expressly state that QVECs will not be applied against the 10% safe harbor, thereby permitting an employee to make nondeductible voluntary contributions up to the 10% safe harbor limit (subject to Code section 415 limits) in addition to deductible contributions of up to \$2,000 for any taxable year or if less, 100% of his or her compensation for that year. Final resolution of the matter, however, must await an IRS regulation or ruling. An employee eligible to make QVECs to a qualified plan may always prefer instead to contribute to an IRA outside the plan. Presumably, any regulation requiring reduction of the 10% limit to take into account QVECs would treat IRA contributions similarly.

11. *A New Type of Plan?*

An unanswered question exists concerning whether an employer, even though maintaining other qualified plans, can establish a separate qualified plan just for QVECs which would be something other than a Code section 408(c) arrangement. One advantage of this approach would be that such a plan would be administratively less confusing to both the plan administrator and the employees than a combination plan.¹²⁸ Furthermore, such a plan could have advantages over a pooled IRA arrangement with

standards must themselves constitute a nondiscriminatory group of employees. It should be noted that the Notice (in Q. and A. I-11) also allows a plan to permit any employees to make QVECs, even if they do not otherwise participate in the plan. The Notice further states (in Q. and A. I-17) that it is not discriminatory to limit QVECs to a stated percentage of compensation of each employee.

124. Rev. Rul. 80-350, 1980-2 C.B. 133.

125. 1981-41 I.R.B. 7. This rule determines what "voluntary" contributions are for the "10%-safe harbor" rule.

126. Rev. Rul. 80-350, 1980-2 C.B. 133.

127. IRS Notice 82-3, 1982-9 I.R.B. 12; IRS Notice 82-13 (Q. and A. I-15), 1982-19 I.R.B. 15.

128. See *supra* notes 68-71 and accompanying text.

respect to the federal securities laws.¹²⁹

However, such a plan, unless invested primarily in the plan employer's securities so as to be able to be described as a stock bonus plan, may not technically qualify under Code section 401(a). The IRS has previously ruled that a plan funded entirely by employee contributions will not fail to qualify under Code section 401(a) merely because all contributions are made by employees (as long as the plan is not one established by the unilateral action of employees).¹³⁰ Current regulations, however, still demand that a pension plan have benefits which are definitely determinable and that a profit sharing plan provide for contributions from employer profits.¹³¹ The IRS has ruled, however, that a plan under which employee contributions may vary to some extent, and employer contributions are fixed as a percentage of the employee contributions, will qualify as a money purchase pension plan, since employer contributions are determined by an express formula not subject to employer discretion.¹³² Moreover, the IRS now holds that the elimination of any employer contributions will not affect such a plan's status as a money purchase pension plan.¹³³

If a separate plan consisting only of employee contributions is deemed a money purchase pension plan by the IRS, it would be expected that the employee contributions would not lose their "voluntary" nature (as required for deductibility) merely because such contributions are required in order to participate in such a plan. In this regard, recent statements of the staffs of the IRS and the Joint Committee on Taxation indicate that a separate plan for employee contributions is intended to be permitted, provided each employee in a nondiscriminatory classification is a participant

129. It appears that the staff of the Securities and Exchange Commission Division of Corporate Finance is taking the position that financial institutions which offer pooled IRA arrangements will be subject to the registration requirements of the Securities Act of 1933, while financial institutions which utilize master plans qualified under I.R.C. § 401(a) (1976 & Supp. IV 1980) and providing for QVECs may avoid such requirements. It appears likely at this time that the Securities and Exchange Commission Division of Investment Management staff will take a similar position with respect to registration under the Investment Company Act of 1940, as amended. *Fiduciary Trust Company of New York*, 5 PENS. PLAN GUIDE (CCH) ¶ 23,595D (December 28, 1981); *United Missouri Bank of Kansas City, N.A.*, 5 PENS. PLAN GUIDE (CCH) ¶ 23,593E (December 1, 1981).

130. Rev. Rul. 80-306, 1980-2 C.B. 131.

131. Treas. Reg. § 1.401-1(b)(1)(i), 1964-1 (Part 1) C.B. 144; Treas. Reg. § 1.401-1(b)(1)(ii), 1956-2 C.B. 219.

132. Rev. Rul. 74-385, 1974-2 C.B. 130.

133. IRS Notice 82-13 (Q. and A. I-4), 1982-19 I.R.B. 15.

therein regardless of whether he makes contributions.¹³⁴ This raises a question, however, as to whether an employee who makes no contributions can actually participate in a plan if the plan only provides benefits for those employees who make contributions.

12. *Government Reports*

ERTA section 311(a), amending Code section 219, requires administrators of plans that allow QVECs to provide to both plan participants and the IRS reports which IRS regulations may prescribe.¹³⁵ A document similar to the disclosure statement required by Treasury Regulation section 1.408-6, which disclosure statement is to be given IRA owners by the sponsors of IRAs, may possibly be required. This could be a significant burden. In addition, ERTA section 311(f), amending Code section 6652(h), provides that a failure to make a required report will subject the plan administrator to a penalty in an amount equal to twenty-five dollars for each participant with respect to whom the report failure relates multiplied by the number of years during which the failure continues. The maximum penalty is \$10,000.¹³⁶

13. *Tax Withholding Rules*

Code section 3401(a)(12)(D) states that remuneration paid as described in Code section 219(a) is exempt from federal income tax withholding if it is reasonable to believe that the employee will be entitled to a deduction for the payment. This Code section appears to allow amounts forwarded by the employer, either to an IRA, or as allowable QVECs, to be exempt from federal income tax withholding. However, the regulation could be read to apply only to *employer* contributions on behalf of employees to IRAs. The IRS recently has stated that this section will apply to employee contributions to IRAs and to QVECs made by reason of payroll deductions.¹³⁷ Proposed IRS regulations would allow, after 1981, an employee to take into account his or her estimated deductible contributions under Code section 219 (which include QVECs or employee monies forwarded to an IRA), to the extent

134. STAFF EXPLANATION, *supra* note 36, at 203; IRS Notice 82-13 (Q. and A. I-5), 1982-19 I.R.B. 15.

135. I.R.C. § 219(f)(4) (West Supp. 1982).

136. The risk of onerous reporting rules may discourage plans from permitting QVECs until IRS reporting requirements are firmly in place.

137. IRS Notice 82-13 (Q. and A. I-21), 1982-19 I.R.B. 15. The staff of the Joint Committee on Taxation has indicated its belief that QVECs are exempt from federal income tax withholding. STAFF EXPLANATION, *supra* note 36, at 203.

no exclusion is made under Code section 3401(a)(12), in determining his or her withholding allowances under Code section 3402.¹³⁸ There is, however, no exclusionary rule for IRAs or QVECs with respect to the Federal Insurance Contributions Act or the Federal Unemployment Tax Act.¹³⁹ Of course, state and local income taxes cannot be disregarded.

14. *Considerations in Allowing QVECs*

There are a number of potential benefits for employees when an employer's qualified plans are allowed to accept QVECs. These potential benefits may not be similarly enjoyed by contributions to an IRA. For example, a frequently cited advantage of allowing acceptance of QVECs is that adding such contributions to other plan funds for investment purposes may allow investment opportunities which are unavailable for the smaller investment "pots" pertaining to IRA contributions. Also, through some qualified profit sharing or stock bonus plans, QVECs may be invested in the plan employer's securities, an investment opportunity generally unavailable to IRA contributions. The attractiveness of this latter opportunity, however, is diminished because any distribution of employer securities attributable to QVECs will be subject to taxation upon distribution; the special deferral rule for unrealized appreciation on employer securities under Code section 402(a)(1), as amended by ERTA, is specifically made inapplicable to such securities if attributable to QVECs.¹⁴⁰ Furthermore, it appears that the unrealized appreciation would be taxed as ordinary income.

A further potential advantage is the possibility that employers will be able to pay all transactional fees associated with fund investments as part of the plan's administrative expenses rather than charging such amounts to plan accounts, thereby increasing the effective value of contributions. Additionally, plans which allow employees to direct the investment of their accounts might pro-

138. Prop. Treas. Reg. § 31.3402(m)-1(b)(4), 8 Fed. Taxes (P-H) ¶ 53,587, at ¶ 53,588.3 (1981).

139. Note that contributions to a Simplified Employee Pension Plan as remuneration are not subject to withholding for Federal Insurance Contributions Act purposes under I.R.C. § 3121(a)(5)(D) (Supp. IV 1980), or for Federal Unemployment Tax Act purposes under *id.* § 3306(b)(5)(D) if it is reasonable to anticipate that the employee will be entitled to a deduction under I.R.C. § 219 (1976 & Supp. IV 1980), but these rules are carefully limited to SEP-IRAs.

140. See *supra* note 87 and accompanying text.

vide more investment flexibility than that available under a typical IRA.

A significant factor in assessing the comparative advantages of QVECs and IRAs may be the ability of creditors to gain access to funds. ERISA and the Code clearly prohibit assignment or alienation, including attachment, of amounts in qualified plans,¹⁴¹ although a judicial exception has been found in the area of family obligations.¹⁴² Presumably, QVECs will also be afforded this protection.¹⁴³ Neither the Code nor ERISA grants such protection to an individual retirement account established under Code section 408(a). Thus, QVECs may be better protected from the claims of creditors than individual retirement account funds. Note, however, that individual retirement annuities or bonds established under Code sections 408(b) or 409(a) may not be "transferable." Whether this requirement provides protection from creditors for amounts invested therein is uncertain.¹⁴⁴

Another frequently cited advantage of allowing an employer's qualified plans to accept QVECs is that payroll deductions allow for a convenient and relatively painless method for making deductible contributions. However, payroll deductions can also be set up for an IRA program, and the elimination of the "active participant" rule will certainly lead to more use of this approach.¹⁴⁵ Further, if payroll deductions are used in an employer-maintained plan, the plan administrator, as a practical matter, may have to credit interest or earnings thereon throughout the year as deductions are made. Some plans, which use only one valuation date at the end of a plan year for allocating interest and earnings may be "unfair" to a participant who has contributed throughout a year. These plans may, therefore, wish to modify their accounting methods.¹⁴⁶

An employee who makes either QVECs to an employer plan

141. I.R.C. § 401(a)(13) (1976); ERISA § 206(d)(1).

142. *See* Stone v. Stone, 632 F.2d 740 (9th Cir. 1980).

143. Neither the I.R.C. nor ERISA draw any distinction between employer-derived and employee-derived amounts in this regard.

144. I.R.C. § 408(b)(5) (1976) provides that the IRA annuity contract must not be "transferable by the owner." *Id.* § 409(a)(5) simply states that the bond must not be "transferable." *Cf. id.* § 401(g) (1976) (limiting transferability of annuity contracts, effective for taxable years beginning after December 31, 1962).

145. *See supra* notes 15-19 and accompanying text.

146. Adoption of regulation § 1204.118, 46 Fed. Reg. 53,395 (to be codified in 12 C.F.R. § 1204.118), by the Depository Institutions Deregulation Committee which eliminates interest rate ceilings on certain certificates of deposit held by IRAs and Keogh plans may also affect the relative merits of different approaches.

or contributions to an IRA must have funds that will not be currently needed. Whether such amounts will be available will depend to some extent on foregone investment opportunities. This may be especially important where an employer under a thrift plan matches certain employee contributions made in the employee's discretion, and the employee does not desire to make both matched employee contributions and QVECs. Numerous factors may influence an employee in the decision to make matched employee contributions or, alternatively, either IRA contributions or QVECs. On the one hand, the "matched" contributions, unlike the QVECs or IRA contributions, will not be tax deductible.¹⁴⁷ On the other hand, matched contributions will be matched to some degree by employer contributions.¹⁴⁸ A severe vesting schedule for employer contributions may negate, to some extent, this advantage of matched contributions. Furthermore, matched contributions, as well as other nondeductible employee contributions, may, depending on plan provisions, be distributable without penalty before attainment of age fifty-nine and one-half or disability.¹⁴⁹ QVECs or IRA contributions are, however, subject to this penalty.¹⁵⁰ Finally, matched contributions, and nondeductible employee contributions in certain cases, may be eligible for favorable tax treatment associated with qualified plan distributions,¹⁵¹ whereas QVECs or IRA contributions will not be so eligible.

The acceptance of QVECs by an existing plan will be attractive to employers, since that will likely increase employee morale. The degree to which employees recognize advantages over simply contributing to an employee-established IRA may be the prime consideration for the employer.

If qualified plans have the ability to accept QVECs, the employer is likely to face certain difficulties. There will be an increased number of plan participants, an increase in administrative

147. They will not be considered "voluntary" as required by I.R.C. § 219(e)(2)(B) (West Supp. 1982). If made under a cash or deferred plan under I.R.C. § 401(k) (Supp. IV 1980), they will be deemed employer contributions not included in income, however.

148. Obviously the employee's tax bracket will be a factor of significance.

149. The IRS has in the past placed few restrictions on withdrawal of employee contributions.

150. See *supra* note 119 and accompanying text.

151. For example, unrealized appreciation in employer securities purchased with employee contributions would not be included in gross income upon distribution pursuant to I.R.C. § 402(a)(1) (West Supp. 1982), if purchased with nondeductible employee contributions but would be includible if purchased with "allowable" QVECs.

costs for plan accounting and for reports to the government, an increased potential for liability, and an increased risk of penalties for failure to file required government reports.

C. Keogh Plan Changes

Before turning to changes made in the Keogh (i.e., self-employed) plan area by ERTA, it should be noted that the 1982 Tax Equity Act has effected a further major overhaul in this area. In general, the 1982 Tax Equity Act has made the rules (including deduction and contribution rules) the same for corporate and Keogh plans, specifying more restrictive rules only for certain top-heavy plans (i.e., plans benefiting mainly key employees, regardless of whether such plans are corporate or Keogh). These 1982 Tax Equity Act changes, however, are generally not effective until years beginning after 1983.¹⁵² Thus, the below-discussed rules are still effective until such time and must not be ignored.

1. Deductible Limits Raised for Defined Contribution Plans

Prior to ERTA, the deductible limit for a defined contribution Keogh plan (i.e., a defined contribution plan benefiting at least some self-employed persons) for any self-employed person for one taxable year was the lesser of (1) \$7,500 or (2) 15% of the self-employed person's annual earned income derived from that trade or business for which the plan was established.¹⁵³ ERTA section 312(a), in amending Code section 404(e), has increased this deductible limit for a self-employed person by changing the absolute dollar figure from \$7,500 to \$15,000.¹⁵⁴ This increase applies "to plans which include [self-employed persons] with respect to taxable years beginning after December 31, 1981."¹⁵⁵ This language appears to indicate that the increase is effective for the taxable years of the *employer* beginning after December 31, 1981.¹⁵⁶ This

152. Tax Equity Act §§ 237, 240, 241.

153. I.R.C. § 404(e)(1), (e)(2)(A) (1976).

154. I.R.C. § 404(e)(1), (e)(2)(A) (West Supp. 1982). After 1983, Tax Equity Act §§ 235, 237, and 241 increase these deductible limits to the same as corporate plans (i.e., generally the lesser of \$30,000 (increased after 1985 for cost of living increases) or 25% of compensation (or earned income)). This increase is accomplished by eliminating the special restrictions on contributions formerly applicable to the self-employed and by adjusting the definition of "earned income" in I.R.C. § 401(c)(2) (1976) to exclude the contributions from earned income.

155. ERTA § 312(f)(1).

156. This conclusion appears appropriate because the deduction is determined for the taxable year of the partnership, for example, and not the individual partner for whom the contribution is made. See *Arkin v. Comm'r*, 76 T.C. 1048 (1981) (the dollar limitations on

result, however, could prove unfavorable to the involved individuals. To illustrate, assume that a partnership is on a November 1 to October 31 fiscal year. As the IRS has recently explained,¹⁵⁷ the increase in deductible limits would not be effective until the taxable year ending October 31, 1983.¹⁵⁸

2. *Increase in Annual Compensation Taken into Account*

Prior to ERTA, in determining contributions to the plan account of an employee, including a self-employed person, a Keogh defined contribution plan could take into account only the first \$100,000 of the employee's annual compensation.¹⁵⁹ ERTA section 312(b)(1), in amending Code section 401(a)(17), increases the amount of annual compensation which may be taken into account to \$200,000.¹⁶⁰ The same provision also states that if more than \$100,000 in annual compensation is taken into account, contributions made on behalf of any employee other than a self-employed person under the defined contribution plan must be made at a rate of no less than 7.5%.¹⁶¹ For years beginning after 1983, the 1982 Tax Equity Act eliminates these restrictions.¹⁶²

The new rules provided by ERTA may be illustrated by the following example. Assume that sole proprietor X has a defined contribution Keogh plan benefiting X and employee Y. In the plan year, X earns \$300,000 and Y earns \$10,000. If X desires to accrue the maximum contribution under the plan, X can contribute on his or her own behalf 7.5% of the first \$200,000 of X's earned income, or \$15,000, and on behalf of Y, 7.5% of Y's compensation, or \$750. Assuming the same facts, except that X would rather accrue a contribution of only \$10,000, X effectively contributes on his or her own behalf 5% of the first \$200,000 of X's earned income. However, X must still contribute, on behalf of Y, 7.5% of Y's compensation for the year, since the plan takes into account more than \$100,000 in determining contributions.

The 7.5% contribution may be subject to reduction by integra-

deductions taken within one taxable year contained in I.R.C. § 404(e) apply to the taxable year of a partnership, not to the taxable years of the individual partners).

157. IRS Notice 82-13 (Q. and A. II-7), 1982-19 I.R.B. 15.

158. Note that, as under prior law, this limit is applicable only to self-employed individuals covered by the plan. I.R.C. § 404(e)(1) (1976). In theory these limits need not restrict contributions for common-law employees.

159. *Id.* § 401(a)(17) (1976).

160. I.R.C. § 401(a)(17)(A) (West Supp. 1982).

161. *Id.* § 401(a)(17)(B)(i).

162. Tax Equity Act §§ 237, 241.

tion with Social Security or other retirement plans. Although the statute is silent on that issue,¹⁶³ the IRS has recently stated that integration with Social Security is permissible, provided that if over \$100,000 annual compensation is taken into account in determining the making or allocation of contributions, the contributions, including amounts deemed contributed under the integration formula, on behalf of a common law employee must be made at a rate of at least 7.5%.¹⁶⁴ Integration is currently allowed, however, only in limited situations for Keogh plans under Code section 401(d)(6).¹⁶⁵

The increase in the amount of annual compensation taken into account for Keogh defined contribution plans is effective for taxable years beginning after December 31, 1981.¹⁶⁶ It is unclear, however, whether the date is effective for the employer's or employee's taxable years. It is possible that the increase may relate to the employee's taxable year since it is tied to Code section 401 and not to Code section 404(e). However, until IRS regulations resolve the matter, it must be assumed the changes are tied to the employer's taxable year.

ERTA also modifies the rules applicable to defined benefit Keogh plans. For years beginning after 1983, the 1982 Tax Equity Act allows defined benefit Keogh plans to follow all the same rules as apply to defined benefit corporate plans, and thereby generally to accrue an annual benefit for any participant up to the lesser of \$90,000 (increased after 1985 for cost-of-living increases) or 100% of the participant's average annual compensation (or earned income not contributed to the plan) for the highest three years.¹⁶⁷ Until such provisions take effect, however, only Code section 401(j), which is repealed after 1983, allows defined benefit plans benefiting self-employed persons to be established. That section contemplates a plan in which, in most cases, the final retirement benefit provided any employee, whether a self-employed person or a common law employee, is the sum of the benefits the employee has accrued each year under the plan. An employee will be allowed to accrue an annual benefit, computed for all pur-

163. See S. REP. NO. 144, 97th Cong., 1st Sess. (1981); H.R. REP. NO. 201, 97th Cong., 1st Sess. 141 (1981). STAFF EXPLANATION, *supra* note 36, at 209.

164. IRS Notice 82-13 (Q. and A. II-6), 1982-19 I.R.B. 15.

165. After 1983, the special limitation on integration for Keogh plans is eliminated. Tax Equity Act §§ 237, 241.

166. See *supra* notes 155-58 and accompanying text.

167. Tax Equity Act §§ 235, 237, 238, 241.

poses as a single life annuity beginning at age sixty-five with no ancillary benefits, equal to his compensation earned for that year multiplied by a plan accrual rate.¹⁶⁸

In determining an employee's accrued benefit, the same increase in the maximum amount of annual compensation from \$100,000 to \$200,000 that is taken into account in determining contributions applies.¹⁶⁹ However, defined benefit Keogh plans under Code section 401(j) are further limited in the amount of the annual benefit which may be accrued for any year on behalf of a self-employed person.¹⁷⁰ This maximum annual accrual for a self-employed person cannot exceed the product of his or her compensation for the year multiplied by a statutory accrual percentage specified by statute and regulations.¹⁷¹ The applicable statutory accrual percentage is based on the person's age when his or her current period of plan participation begins.¹⁷² The percentages decrease with age. At age thirty or under, the statutory accrual percentage is 6.5%; at age fifty, 3.0%; at age sixty or over, 2.0%. These percentages were not changed by ERTA.¹⁷³ However, ERTA did increase the maximum amount of annual compensation of a self-employed person that could be taken into account in determining his or her maximum annual accrual under the statutory formula from \$50,000 to \$100,000.¹⁷⁴

Similar to the defined contribution rule, ERTA section 312(b)(1), in amending Code section 401(a)(17) (which is deleted after 1983), appears to require that if a defined benefit Keogh plan takes into account more than \$100,000 of annual compensation in determining any employee's, including a self-employed person's, annual benefit accrued for a year, the accrued annual benefit for such year for any employee other than a self-employed person must be not less than such employee's compensation for the year, up to the maximum allowed limit, multiplied by one-half of the statutory accrual percentage applicable to such employee. Although the wording of this provision is somewhat ambiguous, this appears to be its intent.¹⁷⁵

168. I.R.C. § 401(j) (West Supp. 1982).

169. See *supra* notes 159-60 and accompanying text.

170. I.R.C. § 401(j)(2) (West Supp. 1982).

171. I.R.C. § 401(j)(3) (1976); Treas. Reg. § 1.401(j)-1(c) (1981).

172. I.R.C. § 401(j)(3) (1976).

173. *Id.*

174. I.R.C. § 401(j)(2) (West Supp. 1982).

175. See STAFF EXPLANATION, *supra* note 36, at 209. In addition, IRS Notice 82-13, 1982-19 I.R.B. 15, expressly supports this view.

As an example, assume A is a sole proprietor who also employs one common law employee, Y. In 1982, A earns \$300,000 and Y earns \$10,000. Also during the year, A turns fifty while Y turns thirty. A desires to adopt a new defined benefit Keogh plan for 1982 and, under such plan, to make A's annual accrued benefit as high as possible, while keeping Y's annual accrued benefit as low as possible. The maximum annual benefit A can accrue under the plan for 1982 is determined by the formula. Compensation, up to the \$100,000 maximum, is multiplied by the statutory accrual percentage for a person age fifty when plan participation begins. A's maximum accrued annual benefit for 1982 is, therefore, \$3,000 ($\$100,000 \times 3.0\%$).

If the plan takes into account up to \$200,000 in annual compensation in determining the annual accrual under the plan, the plan accrual rate for A would be 1.5% ($\$200,000 \times 1.5\% = \$3,000$, the maximum accrued annual benefit for A for 1982). However, if more than \$100,000 is used in calculating the annual benefit accrued for a year under the plan, the accrual rate applicable to Y could not be less than one-half of the applicable statutory accrual percentage for a person age thirty when plan participation begins, or 3.25% (one-half of 6.5%). If the plan were to take into account only the first \$100,000 in determining annual compensation, however, the plan accrual rate with respect to A for 1982 would be 3.0% ($\$100,000 \times 3.0\% = \$3,000$, the maximum accrued annual benefit for A for 1982). And, since no more than \$100,000 is taken into account, the special rule set forth above is not applicable.

As a result, the accrual rate for both A and Y under the plan can be 3.0%. For 1982, the annual benefit accrued by A is \$3,000 ($\$100,000 \times 3.0\%$), and the annual benefit accrued by Y is \$300 ($\$10,000 \times 3.0\%$). This provides the maximum benefit for A, while keeping the cost of Y's benefit as low as possible. Note, however, that the limitations of Code section 415 have not been considered here, and they may possibly restrict the maximum projected benefit for an employee.

As in the case of defined contribution Keogh plans, the increases in the amount of annual compensation taken into account for the above items are effective for taxable years beginning after December 31, 1981.¹⁷⁶ There is, however, a special rule for pre-

176. ERTA § 312(f)(1). See *supra* notes 155-58 and accompanying text for a discussion of the concern over whose taxable year is referred to by the statute. This concern is also present here.

existing defined benefit Keogh plans. ERTA section 312(c)(4), in amending Code section 401(j)(3), provides that if an existing defined benefit Keogh plan increases the maximum annual compensation taken into account pursuant to the formula and Code changes discussed above, the increase will be treated as beginning a new period of plan participation. If this occurs, the statutory accrual percentage, based on age when current period of plan participation begins, will decrease.

As an example of the new rule, assume that sole proprietor A adopts in 1981 a defined benefit Keogh plan, which plan provides the maximum accrual for A. In 1981, A is age thirty and earns compensation of \$200,000. Under the formula effective in 1981, the maximum annual benefit accrued by A for 1981 is the product of A's compensation for that year, up to \$50,000, multiplied by the statutory accrual percentage at age thirty, or \$3,250 ($\$50,000 \times 6.5\%$).

Suppose that the formula for determining his or her accrual is amended the very next year (1982) to take into account up to \$100,000 of compensation. In 1982, A's compensation still is \$200,000. Under the new formula, the maximum annual benefit accrued by A for 1982 is the product of A's compensation for that year, up to \$100,000, multiplied by the statutory accrual percentage at age thirty-one, 6.3% (and not 6.5%), or \$6,300 ($\$100,000 \times 6.3\%$). Under the proposed Technical Corrections Act of 1982, however, the increase in compensation will be treated as beginning a new period of plan participation only as to the change.¹⁷⁷

3. *Limitations on Use of Keogh Plan Assets Extended to All Partners and Expanded*

This is an area heavily affected by the 1982 Tax Equity Act. Before turning to the effects of that act, it is helpful to point out that prior to ERTA, if an owner-employee¹⁷⁸ assigned or pledged his or her Keogh plan account, or borrowed directly or indirectly on an insurance contract held in such account, the portion of the account so involved was treated as a distribution to the owner-employee under section 72(m)(4) of the Code. A loan to the owner-employee from his or her Keogh plan account (other than a loan from an insurance contract held therein), however, was not

177. H.R. 6056, 97th Cong., 2d Sess. (1982).

178. Owner-employee is defined in I.R.C. § 401(c)(3) (1976) as a sole proprietor or a partner owning more than 10% of either the capital interest or the profits interest in a partnership.

treated as a plan distribution but as a prohibited transaction subject to excise tax under Code section 4975(c)(1)(B). ERTA section 312(d) amends Code section 72(m) by providing that a loan from a Keogh plan account to an owner-employee will be considered as a distribution to the owner-employee.¹⁷⁹ Thus, under ERTA the amount loaned will be includible in the owner-employee's gross income (assuming the borrowing is not of employee contributions). If the loan is made before the owner-employee attains age fifty-nine and one-half or is disabled, however, the "deemed" distribution will be subject to the 10% tax on premature distributions imposed on owner-employees under Code section 72(m)(5).

Again postponing consideration of the new 1982 Tax Equity Act changes for the moment, ERTA section 312(d) extends the above rules pertaining to deemed distributions to all partners in a partnership.¹⁸⁰ Thus, under ERTA the use of a Keogh plan account by any partner, even if not an owner-employee, as an assignment or pledge or a loan under an insurance contract held in the account or for a loan made directly from the account will be a deemed distribution from the plan and subject to inclusion in gross income. A distribution to a partner who is not by definition an owner-employee, however, will not be subject to the 10% tax on premature distributions applicable to owner-employees because section 72(m)(5) of the Code, which imposes the premature distribution tax, has not been extended to partners with an interest of 10% or less.¹⁸¹ Likewise, a loan to a partner who is not an owner-employee generally will not be a prohibited transaction.¹⁸²

The new limitations imposed by ERTA section 312(d) are generally effective for taxable years beginning after December 31, 1981. The loan prohibition will not apply to a loan from a Keogh plan to a self-employed person which is outstanding on that date, but any outstanding loan that is renegotiated, extended, renewed, or revised will be treated as a new loan and thereby subject to the ERTA provisions.¹⁸³ As indicated above, however, the 1982 Tax Equity Act has changed the rules for all self-employed persons relating to loans made from qualified plans, the use of plan accounts as an assignment or pledge, or the borrowing under a contract held in the plans. In all such cases, beginning generally with

179. I.R.C. § 72(m)(8) (West Supp. 1982).

180. *Id.* § 72(m)(6).

181. *Id.*

182. I.R.C. § 4975(c)(1)(B), (d).

183. ERTA § 312(f)(1), (2).

loans, assignments, or pledges made after August 13, 1982, the amount loaned, assigned, or pledged will not be treated as distributed up to a certain limit and will be treated as distributed above such limit. The limit, below which the total amount of plan loans, assignments, or pledges for a participant will not be deemed distributed, depends on the then current present value of the participant's nonforfeitable accrued benefit and/or account balance under all of the employer's plans. If such value is in excess of \$100,000, loans, assignments, or pledges up to \$50,000 can be made without a distribution being deemed to result; if such value is between \$20,000 and \$100,000, loans, assignments, or pledges up to one-half of such value can be made; and, if such value is less than \$20,000, loans, assignments, or pledges up to \$10,000 can be made. For purposes of these post-August 13, 1982 rules, any outstanding loan which is renegotiated, extended, renewed, or revised after that date will generally be treated as a new loan subject to the new 1982 Tax Equity Act provisions.¹⁸⁴ Any deemed distributions to any key employee (which is a broader term than owner-employee) under a top-heavy plan (i.e., a plan benefiting mainly key employees in a year beginning after 1983) may be subject to the 10% tax on "premature distributions."¹⁸⁵ Finally, it is important to keep in mind that the 1982 Tax Equity Act did not change the rule that a loan to an owner-employee is a prohibited transaction subject to excise tax.¹⁸⁶

4. *Return of Excess Contributions Before Tax Return Filing*

Deductible contributions by an employer to a Keogh plan are subject to monetary limits. For defined contribution Keogh plans, the deductible limit on the amount that can be contributed on behalf of any self-employed person for any one taxable year is, as amended by ERTA, the lesser of (1) \$15,000 or (2) 15% of the self-employed person's compensation for the taxable year.¹⁸⁷ For years beginning after 1983, such deductible limit is the general Code section 415 limit for all plans (i.e., generally the lesser of \$30,000 (increased after 1985 for cost-of-living increases) or 25% of the person's compensation (or earned income not contributed to the plan) for the year).¹⁸⁸ Generally, for defined benefit Keogh

184. Tax Equity Act § 236.

185. *Id.* §§ 237, 241.

186. I.R.C. § 4975(c)(1)(B), (e)(2).

187. I.R.C. § 404(e) (West Supp. 1982).

188. Tax Equity Act §§ 235, 238, 241.

plans, the limit on employer contributions is the full funding limit for the plan,¹⁸⁹ and for years beginning after 1983, the lesser of the full funding limit or the Code section 415 limit (i.e., generally, with respect to any employee, the lesser of \$90,000 (increased after 1985 for cost-of-living increases) or 100% of the employee's average annual compensation (or earned income not contributed to the plan) for the highest three years).¹⁹⁰ Under Code section 4972(a), any "excess contributions" beyond those limits are subject to a 6% excise tax. While the 1982 Tax Equity Act eliminates Code section 4972 and the 6%-excise tax penalty for years beginning after 1983,¹⁹¹ the possibility of penalty will exist until then.

With respect to the Code section 4972(a) penalty, prior to ERTA if an excess contribution was made by an employer to a Keogh plan in a taxable year, it could not be corrected to avoid the excise tax for that taxable year.¹⁹² Rather, correction of the excess contribution in the taxable year of the contribution only prevented the excise tax from being imposed in later taxable years.¹⁹³ ERTA section 312(e) amends Code section 72(m) to allow the correction of the excess contribution to prevent the excise tax from being imposed for the taxable year of the contribution for the time the penalty remains applicable.¹⁹⁴

The correction is effected by the distribution of the excess contribution if the following requirements are met: the distribution is made on or before the date, including extensions, for filing the employer's tax return for the taxable year in which the excess contribution was made; no deduction is taken by the employer for the excess contribution; and the distribution is accompanied by the net income attributable to the excess contribution.¹⁹⁵ This net income is includible in the recipient's gross income for the taxable year in which received.¹⁹⁶ Once the correction of the excess contribution is made, it is treated as if no excess contribution was ever made.¹⁹⁷ Therefore, no excise tax under Code section 4972 is ever imposed. However, a correction of the excess contribution made

189. I.R.C. § 4972(b)(3) (1976). This is also essentially a deductibility issue.

190. Tax Equity Act §§ 235, 241.

191. *Id.* §§ 237, 241.

192. I.R.C. § 4972(b)(1) (1976).

193. *Id.*

194. I.R.C. § 72(m)(9) (West Supp. 1982).

195. *Id.* § 72(m)(9)(C). ERTA § 312(e)(1), in defining a qualified distribution, adopts the requirements outlined in I.R.C. § 408(d)(4) (1976).

196. *Id.*

197. I.R.C. § 4972(b)(6) (West Supp. 1982).

after the return period for the taxable year in which the contribution was made will not avoid the 6% excise tax. This late correction only prevents the imposition of the excise tax in subsequent taxable years.¹⁹⁸ The provisions allowing the correction of an excess contribution for the taxable year of the contribution are effective for taxable years beginning after December 31, 1981.¹⁹⁹

Code section 4972, while it remains applicable, also imposes a 6% excise tax on excess contributions made to a Keogh plan by an owner-employee in his or her personal capacity.²⁰⁰ For this purpose, the amount permitted currently under Code section 4972 to be contributed by an owner-employee as an employee for any taxable year is the least of (1) \$2,500, (2) 10% of the owner-employee's earned income for the taxable year, or (3) the personal contribution rate allowed employees who are not owner-employees.²⁰¹ If a Keogh plan has no employees other than owner-employees, any personal contribution by an owner-employee would be considered an excess contribution.²⁰² ERTA section 312(e) does not amend section 4972 of the Code as to these excess contributions of owner-employees. Thus, corrections by distribution of an owner-employee's excess contributions in any taxable year, including the year of the contribution, will only prevent the imposition of an excise tax for later taxable years.²⁰³ Also, QVECs made to a Keogh plan by an owner-employee may be deemed excess contributions if the amount contributed exceeds the limits imposed by Code section 4972(c), thereby invoking the imposition of the excise tax.²⁰⁴ This result could not have been the intent of Congress and should be corrected.²⁰⁵

198. I.R.C. § 4972(b)(1) (1976).

199. ERTA § 312(f)(1). After 1983, the penalty tax under I.R.C. § 4972 is eliminated. Tax Equity Act §§ 237, 241.

200. I.R.C. § 4972(b)(2) (1976). This amount is added to the excess contributions under *id.* § 4972(b)(3), (b)(4).

201. I.R.C. § 4972(b)(2), (c) (1976). After 1983, the Tax Equity Act's elimination of I.R.C. § 4972 will mean owner-employees may make contributions to the same level as corporate employees (i.e., generally up to 10% of compensation during plan participation plus QVECs).

202. *Id.* "In any case in which there are no employees other than owner-employees, the amount determined under the preceding sentence shall be zero."

203. *Id.* § 4972(b)(1) (1976).

204. Contributions of an owner-employee subject to the "excess contribution" restrictions under *id.* § 4972(b) apparently include QVECs.

205. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would make this correction.

5. *Elimination of "Five-Year Ban" for Terminating Plans*

Prior to ERTA, Code section 401(d)(5)(C) required Keogh plans to provide that if a premature distribution is made to an employee who is, or was, an owner-employee, and if the distribution is attributable to contributions made on behalf of the employee while he was an owner-employee, then no contributions could be made on the employee's behalf for the five taxable years following the taxable year of the distribution. While there is a question as to whether this provision prohibits participation in any type of qualified plan or whether it applies only to participation as an owner-employee, the IRS and the Tax Court have applied the provision to prohibit any contribution being made on the employee's behalf as an owner-employee to any Keogh plan, regardless of whether such plan is the original plan from which the premature distribution was made.²⁰⁶ Prior to ERTA, this prohibition applied in circumstances in which the original plan making the distribution was terminated, even though the distribution might have been eligible for rollover treatment.²⁰⁷

ERTA section 314(a)(1), in amending Code section 401(d)(5), provides that the five year ban set forth in section 401(d)(5)(C) of the Code will not apply to distributions made on account of termination of a plan. This provision is effective for distributions made in taxable years after December 31, 1980.²⁰⁸ The 1982 Tax Equity Act, moreover, eliminates this "five-year ban" in all cases for years beginning after 1983.²⁰⁹ As a result, until years beginning after 1983 (at which time no penalties will remain), only one penalty will remain with respect to a distribution from a terminating Keogh plan to an employee who is, or was, an owner-employee prior to attainment of age fifty-nine and one-half or disability, even if the distribution is attributable to contributions made on behalf of the employee while he or she was an owner-employee. That penalty will be the additional tax levied on the premature distribution by Code section 72(m)(5) equal to 10% of the amount of the premature distribution. Even this penalty may be avoided by properly rolling over the distribution to an individual retirement plan within sixty days of the distribution.²¹⁰

206. *Ziegler v. Comm'r*, 70 T.C. 139, 144 (1978); Rev. Rul. 78-404, 1978-2 C.B. 156.

207. *See Ziegler v. Comm'r*, 70 T.C. at 144.

208. ERTA § 314(a)(2).

209. Tax Equity Act §§ 237, 241.

210. Rev. Rul. 78-404, 1978-2 C.B. 156.

D. *Subchapter S Plan Changes*

As in the Keogh area, the 1982 Tax Equity Act has made a further major overhaul in this area. In general, the 1982 Tax Equity Act has made rules (including deduction and contribution rules) the same for regular corporate and Subchapter S corporate plans, specifying more restrictive rules only for certain top-heavy plans (i.e., plans benefiting mainly key employees, regardless of whether such top-heavy plans are regular corporate or Subchapter S corporate). These 1982 Tax Equity Act changes, however, as noted before, are generally not effective until years beginning after 1983.²¹¹ The below-discussed rules remain, therefore, in effect at this time and should still be carefully followed where applicable.

1. *Contribution Limits Raised for Defined Contribution Plans*

Prior to ERTA, Code section 1379(b) required a shareholder-employee²¹² to include in gross income for such individual's taxable year, in which a taxable year of the corporation ends, any contributions to the plan made on the shareholder-employee's behalf for the taxable year of the corporation which are in excess of the lesser of (1) \$7,500 or (2) 15% of the shareholder-employee's compensation for the corporate taxable year.²¹³ ERTA section 312(c) amends Code section 1379 by increasing the shareholder-employee's limit on excludible income for one taxable year to the lesser of (1) \$15,000 or (2) 15% of the shareholder-employee's compensation for the corporate taxable year.²¹⁴ The statute fails, however, to indicate the effective date of this change. Presumably, the change will be effective for taxable years beginning after December 31, 1981, the same as for similar Keogh plan changes.²¹⁵ However, the Keogh plan change appears to be tied to taxable years of the employer and not to the taxable years of the individual employees.²¹⁶ Unlike the Keogh plan change, however, which is an increase in the deductible limit under Code section 404(e) generally applicable to an employer, the contribution limits of

211. Tax Equity Act §§ 238, 240, 241.

212. I.R.C. § 1379(d) (1976) defines shareholder-employee as one who owns (directly or by virtue of § 318(a)(1)) more than 5% of the outstanding stock of a Subchapter S corporation.

213. *Id.* § 1379(b)(1) (1976).

214. I.R.C. § 1379(b)(1) (West Supp. 1982).

215. See *supra* notes 156-58 and accompanying text. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. 1982), would confirm the change as effected for taxable years beginning after December 31, 1981.

216. See note 156.

Code section 1379(b)(1), as increased by ERTA section 312(c), are limits on the amount which an individual shareholder-employee can exclude from gross income in his or her taxable years. No change is made in the employer Subchapter S corporation's deductible limits at all. The limits are the general limits imposed by Code section 404(a). As a result, it is assumed this change in Code section 1379(b)(1) is effective for taxable years of affected shareholder-employees which begin after December 31, 1981. If this interpretation is correct, these limit changes can, in most cases, become effective for all of 1982 with no deferral.²¹⁷

2. *Increase in Annual Compensation Taken into Account*

ERTA section 312(b) and (c), amending Code section 401(a)(17) and (j), increases the amounts of annual compensation that can be taken into account under defined contribution and defined benefit Subchapter S plans.²¹⁸ The discussion above regarding the increase in annual compensation which may be taken into account by Keogh plans is generally applicable to Subchapter S plans.²¹⁹ Any reference made therein to a sole proprietor or partnership should be read as referring to a Subchapter S corporation, and reference to a self-employed person should generally be read to refer to a shareholder-employee. Because of the more liberal integration provisions applicable to Subchapter S plans, however, the question of whether the 7.5% contribution floor for defined contribution plans or the minimum applicable percentage for defined benefit plans (where annual compensation above \$100,000 is taken into account) may be integrated becomes even more important.²²⁰ Moreover, for years beginning after 1983, the 1982 Tax Equity Act eliminates these annual compensation limits but introduces compensation limits for top-heavy plans.²²¹

E. *Simplified Employee Pension Plan Changes*

1. *Contribution Limits Raised*

Prior to ERTA, section 219 of the Code allowed an employee

217. Beginning after 1983, however, the Tax Equity Act simply provides an increased limit on contributions made to the Subchapter S plan to the same limit as applies to regular corporate plans (i.e., generally the lesser of \$30,000 or 25% of compensation). Tax Equity Act §§ 238, 241.

218. I.R.C. § 401(a)(17), (j)(2)(A) (West Supp. 1982).

219. See *supra* notes 159-76 and accompanying text.

220. See *supra* note 163-64 and accompanying text.

221. Tax Equity Act §§ 237, 238, 240, 241.

to deduct from gross income contributions made by his or her employer to a simplified employee pension plan established under section 408(k) of the Code with respect to any taxable year of the employee. This deduction was limited to the lesser of (1) \$7,500 or (2) 15% of the employee's compensation for such year.²²² ERTA section 312(c)(1), in amending Code section 219(b)(2)(A), has increased this deductible limit for a taxable year to the lesser of (1) \$15,000 or (2) 15% of the employee's compensation for such year.²²³ It appears to be the intent of the 1982 Tax Equity Act to raise the dollar limit even further for years beginning after 1983, up to the dollar limit under Code section 415 for defined contribution plans (i.e., generally \$30,000, increased after 1985 for cost-of-living increases),²²⁴ although subsequent legislation to explicitly amend the deduction section under Code section 219 is needed to carry out such intent.

The statute again fails to indicate the effective date of the increase made by ERTA. As with similar Keogh and Subchapter S plans, the change will presumably be effective for taxable years beginning after December 31, 1981.²²⁵ As noted above, the similar Keogh plan change appears to tie the effective date change to taxable years of the employer and not to the taxable years of the individual employees.²²⁶ However, unlike the Keogh plan change, which increases the deductible limit under Code section 404(e) generally applicable to an employer, the deductible limits of Code section 219(b)(2)(A), as increased by ERTA section 312(c)(1), represent limits on the amount an individual employee can deduct from gross income in that employee's taxable years. In fact, the limits of deductions for an employer with respect to contributions made to a simplified employee pension plan specifically refer to calendar years, the usual taxable year for individuals.²²⁷ Also, the employer may take deductions for the amount of contributions made during the taxable year of the employer with or

222. I.R.C. § 219(b)(7) (Supp. IV 1980).

223. See I.R.C. § 408(d)(5), (j) (West Supp. 1982). In addition, the employee can make after 1981 an additional contribution to the IRA into which the employer's Simplified Employee Pension Plan contributions are made, up to the IRA deductible limits. IRS Notice 82-13, 1982-19 I.R.B. 15. This is also made clear in the proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982).

224. Tax Equity Act §§ 238, 241.

225. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. 1982) would confirm the effective date of the change.

226. See *supra* note 156.

227. I.R.C. § 404(h)(1)(C) (Supp. IV 1980).

within which such calendar year ends.²²⁸ As a result, it appears relatively certain that this change in individual deduction limits for simplified employee pensions should be effective for taxable years of affected individual employees which begin after December 31, 1981.

2. *Increase in Annual Compensation Taken into Account*

ERTA section 312(b), in amending Code section 408(k), increases the amount of annual compensation which may be taken into account under simplified employee pension plans.²²⁹ The rules in this area are generally the same as they are for Keogh plans. The plan sponsor is treated just as a sole proprietor or partnership is treated under the Keogh plan rules. Similarly, an employee under a simplified employee pension plan is treated generally just as a self-employed person is treated under the Keogh plan rules. As in the case of Subchapter S plans, integration of contributions is broadly accepted. In circumstances involving compensation in excess of \$100,000, contributions, including amounts contributed under the integration formula, must be at a rate not less than 7.5% of compensation.²³⁰ For years beginning after 1983, the 1982 Tax Equity Act eliminates the "7.5% rule," but, unlike the situation for Keogh and Subchapter S plans, it does not eliminate the \$200,000 limit on annual compensation which may be used in determining contributions.²³¹

F. *Changes in Employee Stock Ownership Plans (ESOPs), Stock Bonus Plans and Other Defined Contribution Plans Investing in Employer Stock*

1. *Payroll-Based Tax Credit ESOP*

The Tax Reduction Act of 1975 created the tax credit ESOP,²³² the purpose of which was to provide additional investment credits to employers transferring employer securities to the ESOP. This "investment-based" ESOP credit, which favored capital-intensive businesses, was initially scheduled to expire on December 31, 1983. ERTA section 332(a), in amending Code section 46, accelerates the termination date to December 31, 1982. Any

228. *Id.* § 404(h)(1)(A).

229. I.R.C. § 408(k)(3)(C) (West Supp. 1982).

230. *See supra* note 163-64 and accompanying text.

231. Tax Equity Act §§ 238, 241.

232. I.R.C. § 409A (Supp. IV 1980).

investment-based ESOP credit applicable to a taxable year ending on or prior to December 31, 1982, however, together with all other portions of the Code section 46(a)(1) and (2) total investment credit exceeding the maximum credit allowed under Code section 46(a)(3), may be carried back three years and carried forward seven years. This process is to continue until the excess credits can be used up in the carryback and carryforward years.²³³ Thus, it is still possible for an investment-based ESOP credit arising in a taxable year prior to 1983, in certain situations, to be carried forward and applied as a tax credit in taxable years after 1982.

In determining whether a carryback or carryforward is attributable to an investment-based ESOP credit or to a regular 10% investment credit, the carryback or carryforward is first considered to be due to the regular 10% investment credit and only subsequently to the ESOP credit.²³⁴ If an investment-based ESOP credit is, despite this ordering rule, deemed to be eligible for carryforward to a taxable year after 1982, the contributions of employer securities to the tax credit ESOP, which contributions are required by reason of taking the investment-based ESOP credit in the later year, need not be contributed to the ESOP until thirty days after the due date, including extensions, for the employer's federal income tax return *for such later taxable year*.²³⁵ As a result, despite the termination of the investment-based ESOP credit as of December 31, 1982, certain carryforward provisions may, in certain limited situations, allow such a credit to be taken in taxable years after 1982.

Effective January 1, 1983, ERTA section 331(a) adds a new Code section 44G which creates a payroll-based ESOP credit for corporations. This payroll-based ESOP credit, as the name indicates, is more favorable to labor-intensive businesses. The payroll-based ESOP credit for any taxable year, subject to a maximum limit described below, is equal to the lesser of (1) the value of the employer's securities which are transferred to a tax credit ESOP, such ESOP meeting the standards set forth below for such taxable year, or (2) the applicable percentage of the amount of total compensation paid or accrued during the taxable year to all employees under a tax credit ESOP.²³⁶ IRS regulations are likely to provide that only compensation of those employees actively participating

233. I.R.C. § 46(b) (1976).

234. I.R.C. § 48(n)(1)(D) (Supp. IV 1980).

235. *Id.* § 48(n)(1)(C).

236. I.R.C. § 44G(a) (West Supp. 1982).

in the tax credit ESOP can be considered in determining the payroll-based ESOP credit.²³⁷

The applicable percentage of total compensation is determined in accordance with the following table:²³⁸

For aggregate compensation paid or accrued during a portion of the taxable year occurring in calendar year:	The applicable percentage is:
1983	0.5
1984	0.5
1985	0.75
1986	0.75
1987	0.75
1988 or thereafter	0.

The applicable percentage is based on the total compensation paid or accrued in a calendar year, even if the employer is on a non-calendar fiscal year. For example, if an employer is on a July 1 to June 30 fiscal year, for the year ending June 30, 1985, the payroll-based ESOP credit cannot exceed the sum of (1) 0.5% times total compensation paid or accrued between July 1 and December 31, 1984, and (2) 0.75% times total compensation paid or accrued between January 1 and June 30, 1985. This rule also allows a corporation on a fiscal year basis to claim a payroll-based ESOP credit for that part of the fiscal year ending in 1983 which occurs on and after January 1, 1983. It is unclear, however, whether an employee's compensation for an *entire* taxable year may be used for determining the ESOP credit if the employee becomes a participant in the ESOP after the start of the year. Presumably, the entire year's compensation may be used. The total year's compensation must be used, up to \$100,000, in allocating employer securities to the employee's account under a tax credit ESOP.²³⁹

There is a maximum limit on the amount of payroll-based ESOP credit allowed for any taxable year. This limit is similar to the proposed limit applicable to investment-based ESOP credits.

237. By way of analogy, I.R.C. § 404(a)(3) (1976) provides that the maximum deductible limit for an employer with respect to contributions to a profit sharing plan, for one taxable year, is 15% of compensation otherwise paid or accrued during the taxable year to "all employees under the stock bonus or profit-sharing plan" (plus certain possible carryovers). It has been held that for purposes of determining the "15% of compensation limit" with respect to a taxable year, only compensation for employees entitled to share in the allocation of the employer contribution for such year is to be taken into account. Rev. Rul. 65-295, 1965-2 C.B. 148.

238. I.R.C. § 44G(a) (West Supp. 1982).

239. Treas. Reg. § 1.48-8(d)(6)(iv) (1979).

In general, the limit is 100% of the employer's liability for tax for the taxable year up to \$25,000, and 90% of the liability for tax above \$25,000.²⁴⁰ The "liability for tax" against which the credit limit will be determined is calculated by reducing the tax otherwise owed by the employer corporation by credits prescribed by Code sections with a lower number designation than Code section 44G. Excluded from the reduction are credits allowed under Code sections 31 (credit for wage withholding and special refunds of Social Security tax), 39 (credit for certain uses of gasoline, special fuels and lubricating oil) and 43 (earned income credit).²⁴¹ As a result, the liability for tax equals the tax otherwise owed, reduced by the credits of Code sections 32 (credit for withholding on foreign corporations and relating to interest on tax-free covenant bonds), 33 (credit for taxes of foreign countries and possessions), 38 (investment credit) and 40 (work incentive program credit). It is not clear whether credits under a lower letter designation within Code section 44 also reduce the liability for tax. Such credits include the credits under Code sections 44B (credit for employment of certain new employees), 44D (credit for nonconventional fuel sources), 44E (credit for use of alcohol as fuel) and 44F (credit for qualified research expenditures). In addition, none of the taxes described in the following Code sections will be included as a tax against which the maximum credit for the payroll-based ESOP will be calculated: Code sections 56 (minimum tax for tax preferences), 531 (accumulated earnings tax), 541 (personal holding company tax) and 1351(d)(1) (relating to recoveries of foreign expropriation losses).²⁴² Finally, in determining the limit on a payroll-based ESOP credit for one taxable year (i.e., 100% of the liability for tax up to \$25,000 and 90% of such liability for tax above \$25,000), only one \$25,000 amount will be counted for any one "controlled group of corporations" under Code section 1563(a).²⁴³

If the payroll-based ESOP credit exceeds the maximum limit on the credit for any taxable year, the unused credit shall be carried back three taxable years (even if ending before 1983) and carried forward fifteen taxable years.²⁴⁴ As with the investment-

240. I.R.C. § 44G(b)(1)(A) (West Supp. 1982).

241. *Id.* § 44G(b)(1)(B).

242. *Id.* § 44G(b)(1)(B) (tax not imposed under I.R.C. § 53(a) is not considered as a tax for these purposes).

243. *Id.* § 44G(b)(1)(C). For this purpose, I.R.C. § 1563(a)(4) and (e)(3)(C) (1976) are not considered.

244. I.R.C. § 44G(b)(2)(A) (West Supp. 1982).

based ESOP credit provisions, the use of carryback or carryforward for unused credits is limited to the extent that the maximum limit on the amount of credit for the taxable year to which the carryback or carryforward applies exceeds the amount of the credit determined under the immediately preceding paragraph for such year.²⁴⁵ In addition, a completely new provision, Code section 404(i), is added by ERTA section 331(b) to provide that if any unused credit from one taxable year remains unused at the end of the last taxable year for which carryforward can apply, the unused credit can be deducted from income in the last taxable year.

In a different deduction rule, the statute notes that if a redetermination of credit results in the reduction of a previously taken payroll-based ESOP credit, the corporation apparently can either reduce the amount of securities to be transferred to the ESOP or take a deduction under the regular provisions of Code section 404.²⁴⁶ Section 404 generally allows an annual deduction equal to 15% of compensation of covered employees. Code section 404 also, however, aggregates the tax credit ESOP with other qualified plans of the employer in order to determine whether the limitations of that section are exceeded. Presumably, the deduction, if applicable, is taken for the year of contribution of the securities and not the year of the final determination.

Finally, in determining the proper amount of a payroll-based ESOP credit, special rules exist for certain regulated companies.²⁴⁷ Such rules are designed so as not to give a tax credit if a ratemaking credit is already provided with respect to ESOP contributions.

To obtain a payroll-based ESOP credit, the corporation must first establish a tax credit ESOP meeting the standards of Code section 409A, under which no more than one-third of the employer contributions for any applicable taxable year are allocated to officers, persons owning more than 10% of the employer's stock—excluding stock held in the ESOP—or employees earning at least twice the Code section 415 dollar limit on annual additions to defined contribution plans.²⁴⁸ Twice the section 415 dollar limit for 1983 would be \$60,000. Furthermore, the corporation must also agree to transfer its securities, assigning a value not greater than an amount equal to the applicable percentage for the subject taxable year times the total compensation paid or accrued

245. *Id.* § 44G(b)(2)(B).

246. *Id.* §§ 44G(c)(3), 404(i)(2).

247. *Id.* § 44G(b)(3).

248. *Id.* § 44G(c)(1).

by the employer for that year.²⁴⁹ For this purpose, the value of the employer's securities are, in the case of securities listed on a national exchange, the average of closing prices of such securities for the twenty consecutive trading days immediately preceding the date the securities are contributed to the ESOP.²⁵⁰ With respect to securities not listed on a national exchange, "value" means fair market value determined in good faith and in accordance with regulations yet to be issued.²⁵¹ This raises a question as to whether over-the-counter trading or "regional" exchanges are included in the national exchange twenty-day rule. Treasury regulations under Code section 46 seem to indicate that over-the-counter markets are not national exchanges, in that such regulations differentiate "a system sponsored by a national securities association" from a "national securities exchange."²⁵²

Transfers made to a payroll-based ESOP are subject to rules similar to the transfer provisions applicable to investment-based ESOPs. In order to be effective for a taxable year, the transfers must be made within thirty days after the date, including extensions, for filing the tax return for the specific taxable year.²⁵³ Moreover, cash contributions will be treated as contributions of employer securities if, within thirty days of contribution, the cash is used to purchase employer securities.²⁵⁴ The employer securities to be transferred to a payroll-based ESOP must be: (1) common stock readily traded on an established securities market; or, if none, (2) common stock with rights equal to both those of the class of common stock with the greatest voting power and those of the class with the greatest dividend rights; or, (3) noncallable preferred stock if such stock is convertible at a reasonable price into common stock described in (1) or (2) above.²⁵⁵

A final point with respect to payroll-based ESOPs, and investment-based ESOPs, is that they must meet the standards of Code section 409A. As a result, a payroll-based ESOP must provide that:

(1) For allocation purposes, compensation in excess of \$100,000 for any employee is not to be taken into account;²⁵⁶

249. *Id.* § 44G(c)(1)(B).

250. *Id.* § 44G(c)(7)(A).

251. *Id.* § 44G(c)(7)(B).

252. *Treas. Reg.* § 1.46-8(b)(7)(ii) (1979).

253. *I.R.C.* § 44G(c)(2) (West Supp. 1982).

254. *Id.* § 44G(c)(4).

255. *Id.* § 44G(c)(6).

256. *I.R.C.* § 409A(b)(2) (Supp. IV 1980).

(2) All plan participants must at all times be 100% vested in the securities allocated to their accounts;²⁵⁷

(3) Securities allocated in the plan cannot be distributed before eighty-four months have elapsed from the original allocation, or the employee dies, is disabled, or separates from service;²⁵⁸

(4) If the employer is publicly held, voting rights of allocated securities must be passed through to participants. For non-publicly held companies, pass-through of voting rights is only required for issues decided by more than a majority vote;²⁵⁹

(5) Securities transferred to the plan must remain in the plan even if the tax credit is recaptured or redetermined;²⁶⁰

(6) Participants entitled to distributions must, in most cases, be given the right to demand that distribution be in the form of the securities and, if the securities are not publicly traded, the right for some period to "put" back the securities to the employer;²⁶¹ and

(7) Some provision is made for payment of expenses for establishing and administering the plan from amounts otherwise payable to the plan.²⁶²

2. Changes in Tax Credit ESOP Provisions

Section 409A of the Code prescribes the provisions applicable to tax credit ESOPs. ERTA makes changes in two of the provisions: the timing of distributions, and the form of distributions. As noted before, employer securities allocated in a tax credit ESOP cannot be distributed for eighty-four months after allocation thereof, except in cases of death, disability, or separation from service. The IRS has held, moreover, that a reorganization, sale of a business, etc., involving an employee who remains at the same job, does not constitute a separation from service.²⁶³ ERTA section 337(a), in amending Code section 409A(d), provides, however, that when a participant is transferred from one employer to another, due to either a corporate acquisition or divestiture of a subsidiary, such an employment transfer constitutes an event giv-

257. *Id.* § 409A(c).

258. I.R.C. § 409A(d) (West Supp. 1982).

259. I.R.C. § 409A(e) (Supp. IV 1980).

260. I.R.C. § 409A(g) (West Supp. 1982).

261. *Id.* § 409A(h).

262. *Id.* § 409A(i).

263. Rev. Rul. 79-336, 1979-2 C.B. 187.

ing rise to a permissible plan distribution, even if the eighty-four-month period has not expired. This new provision is effective for distributions made after March 29, 1975.²⁶⁴ It represents a recognition by Congress that distributions have previously been made in the circumstances covered by the new provision, and a desire by Congress to protect those plans which prematurely took advantage of these liberal distribution rules.

Generally, a participant entitled to a distribution must have the right to demand that it be made in the form of employer securities. Furthermore, if the securities are not publicly traded, such participant must have the right to "put" back to the employer the securities. Unless the participant demands that distributions be in the form of securities, distribution can be made in cash. ERTA section 334, in amending Code section 409A(h), however, seems to provide a new rule that when an employer's articles or bylaws restrict the ownership of substantially all employer securities to employees or qualified plans, the plan can provide that distributions will only be made in cash, without allowing the participant the right to demand distribution in stock. Legislative history clearly indicates that this right to limit distribution to a cash option, where an employer's articles or bylaws restrict ownership to employees and qualified plans, applies to tax credit ESOPs and "leveraged" ESOPs.²⁶⁵ The statutory language, however, read literally, would apply the new rule only to stock bonus plans other than tax credit ESOPs or leveraged ESOPs.²⁶⁶

The wording of the new rule explicitly states that the rule does not constitute a violation of Code section 401(a). It is nowhere stated, however, that the new rule fails directly to violate Code section 409A(h). Tax credit ESOPs and leveraged ESOPs fall directly under the Code section 409A(h) requirements, while stock bonus plans other than tax credit or leveraged ESOPs are brought under Code section 409A(h) by virtue of Code section 401(a). Code section 401(a)(23) states that a stock bonus plan will not fail to meet the Code section 401(a) requirements just because the plan provides a cash distribution option, so long as such option meets the rules of Code section 409A(h). Thus, if Congress intended the new "cash distribution option" rule to apply to tax

264. ERTA § 337(b).

265. S. REP. NO. 144, 97th Cong., 1st Sess. 123 (1981); STAFF EXPLANATION, *supra* note 36, at 223.

266. "Leveraged" ESOPs are those which, under I.R.C. § 4975(e)(7) (1976 & Supp. IV 1980), are allowed to borrow from or on the guarantee of a related party.

credit and leveraged ESOPs, pursuant to the legislative history, corrective legislation should be adopted.²⁶⁷ The new rule, in whatever way it is deemed applicable, is effective as to securities acquired after December 31, 1981.²⁶⁸

One further unanswered question involving cash distributions is whether a cash distribution's payment can be deferred. If a "put" option is exercised, current IRS regulations allow the employer's payment to be paid over a period of up to five years.²⁶⁹ A similar right is likely to apply to normal cash distributions.

The duration of the "put" option which must be given to a participant receiving distribution of non-publicly traded employer securities also has been changed by ERTA. Old IRS regulations had required the "put" option to last at least fifteen months.²⁷⁰ Senate reports²⁷¹ under the Revenue Act of 1978²⁷² subsequently indicated that the "put" option needed to last six months after distribution and at least three months in the following taxable year. ERTA section 336, in amending Code section 409A(h), now states that the "put" option must only last for at least sixty days following the date of distribution and for an additional period of at least sixty days in the following plan year. This provision is effective for securities acquired after December 31, 1981.²⁷³

A final change with respect to distributions from ESOPs is made by ERTA section 336, which amends Code section 409A(h). This change provides that if a bank is legally prohibited from redeeming or purchasing its shares, a plan maintained by the bank is not required to repurchase any of the bank's stock which is distributed by the plan. Hence, no "put" option right will exist for persons receiving bank stock from the plan. This provision similarly applies to securities acquired after December 31, 1981.²⁷⁴

3. *Changes in Stock Bonus Plans and Other Defined Contribution Plans Investing in Employer Stock*

Originally, stock bonus plans had to make nearly all distribu-

267. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would apply the "cash distribution option" to tax credit and "leveraged" ESOPs.

268. ERTA § 339.

269. Treas. Reg. § 54.4975-7(b)(12)(iv) (1977); Treas. Reg. § 1.46-8(g)(5) (1979).

270. Treas. Reg. § 54.4975-7(b)(11) (1977); Treas. Reg. § 1.46-8(g)(5) (1979).

271. S. REP. NO. 1263, 95th Cong., 2d Sess. 86-87 *reprinted in* 1978 U.S. CODE CONG. & AD. NEWS 6849-50.

272. Pub. L. No. 95-600, 92 Stat. 2763.

273. ERTA § 339.

274. *Id.*

tions in stock. The Miscellaneous Revenue Act of 1980,²⁷⁵ however, amended this rule to allow stock bonus plans to offer cash distribution options to the same extent as tax credit ESOPs could offer such options.²⁷⁶ ERTA section 335 continues this change by amending Code section 401(a)(23) to apply to the new cash distribution and "put" option rules pertaining to stock bonus plans. These rules are similar in most respects to the rules applicable to tax credit ESOPs.²⁷⁷ The distribution rules applicable to stock bonus plans, however, apply to all employer securities held in the plan and not just to those employer securities described in Code section 409A. In this regard, stock bonus plans can, subject to certain limits, hold nonconvertible nonvoting stock and marketable obligations.²⁷⁸ Tax credit ESOPs under Code section 409A can generally hold only common stock or noncallable convertible preferred stock.²⁷⁹ This new provision affects securities acquired after December 31, 1981.²⁸⁰

A second change made by ERTA concerns voting rights for employer securities held in profit sharing plans. The Revenue Act of 1978²⁸¹ added Code section 401(a)(22) to provide that if a defined contribution plan of an employer, the stock of which is not publicly traded, holds more than 10% of the plan's assets in the employer's own securities, the voting rights provisions for nonpublicly traded stock applicable to tax credit ESOPs apply. This provision requires, therefore, a pass-through of voting rights whenever an issue is decided by more than a majority vote. ERTA section 338(a), however, amends Code section 401(a)(22) to exempt profit sharing plans from this requirement. A plan committee may vote the employer securities held in the plan as to all issues. This provision is effective for acquisitions of securities made after December 31, 1979.²⁸² Money purchase pension plans, which include most thrift plans, were not exempted from the requirements of Code section 401(a)(22).

This new provision contains one point of ambiguity. If a plan's contributions are invested primarily in employer stock but are dependent on employer profits, it is not clearly stated under

275. Pub. L. No. 96-605, 94 Stat. 3521.

276. I.R.C. § 401(a)(23) (Supp. IV 1980).

277. See *supra* notes 232-74 and accompanying text.

278. ERISA §§ 407, 408(e) (codified at 29 U.S.C. §§ 1107, 1108(e) (1976)).

279. I.R.C. § 409A(1) (1976).

280. ERTA § 339.

281. Pub. L. No. 95-600, 92 Stat. 2763.

282. ERTA § 338(b).

IRS regulations whether the plan would be considered a profit sharing plan, a stock bonus plan, or both. Thus, until resolved by regulation, the only certain rule in this area is that a "less-than-50%-employer-security-invested" profit sharing plan is exempt from the rule of Code section 401(a)(22). It is logical, however, for all plans dependent on profits to escape this rule.

4. *New Deductible Limits and Annual Addition Changes for "Leveraged" ESOPs*

Prior to ERTA, the deductible limit for any stock bonus plan was 15% of that year's compensation of employees covered by the plan.²⁸³ If less than the deductible limit was taken, the unused portion of the limit could be carried forward to later years, provided that (1) the carryover to any one later year could not exceed 15% of employees' compensation in such later year, and (2) the total deductible limit for such later year, including the regular deduction and carryovers, could not exceed 25% of such year's compensation.²⁸⁴ If an employer maintained a stock bonus plan and a separate profit sharing plan, the limit would apply to both plans in the aggregate.²⁸⁵ Further, if an employer had a pension or annuity plan and a stock bonus and/or profit sharing plan, the deductible limit, as to all such plans in the aggregate, was 25% of covered employees' compensation for the taxable year.²⁸⁶

ERTA section 333(a) adds Code section 404(a)(10), which provides a new special deduction rule for contributions to a leveraged ESOP, effective for taxable years beginning after December 31, 1981.²⁸⁷ A leveraged ESOP refers to an ESOP which meets the rules of Code section 4975(e)(7),²⁸⁸ and which is thereby eligible to borrow from or on the guarantee of a "disqualified person." The leveraged ESOP must meet the "voting rights" and "put option" requirements of Code section 409A and certain regulations under Code section 4975(e)(7). The requirements of the regulations include: (1) a loan made or guaranteed by a disqualified person must be without recourse against the ESOP, with only the securities obtained with the loan subject to collateral;²⁸⁹ (2) the

283. I.R.C. § 404(a)(3) (1976).

284. *Id.*

285. *Id.*

286. *Id.* § 404(a)(7).

287. ERTA § 339.

288. See Treas. Reg. § 54.4975-7 (1977); Treas. Reg. § 54.4975-11, T.D. 7506, 1977-2, amended by T.D. 7571, 1979-1 C.B. 368.

289. Treas. Reg. § 54.4975-7(b)(5) (1977).

interest rate on such a loan must be reasonable;²⁹⁰ (3) other than certain limited "put options" or "rights of first refusal," no buy-sell or other put or call options, or any arrangements obligating a transaction upon a future event can apply to the ESOP;²⁹¹ (4) all securities obtained from the loan must be held in a "suspense" account and allocated on a proportionate basis as the loan is paid off;²⁹² and (5) other than ESOPs existing prior to November 1, 1977, the ESOP cannot be "integrated" with Social Security.²⁹³

Under the special rule, notwithstanding the deduction limits described above, if contributions to a leveraged ESOP are applied to the payment of principal on a loan incurred for the purchase of employer securities by the due date, including extensions, for filing the employer's tax return for a taxable year, the contributions are deductible up to 25% of that taxable year's compensation of covered employees.²⁹⁴ An amount paid to the ESOP on loan principal in excess of the 25% limit may be carried over and deducted in later taxable years, to the extent that the total deductions owing to loan principal in any later year do not exceed the 25% limit.²⁹⁵

Furthermore, if contributions to the leveraged ESOP are made by the due date, including extensions, for filing the employer's tax return for a taxable year, and are applied to the payment of interest on a loan incurred for the purchase of employer securities, there is no limit on deductibility of such contributions for that taxable year.²⁹⁶ There appears to be no requirement that such contributions for interest payments actually be applied to payment of the interest by the tax return filing date. IRS regulations may eliminate this difference, however, between contributions for the payment of loan principal and interest.

A literal reading of the new deduction provisions indicates that deduction can be taken under both the new, leveraged ESOP deduction provisions and the old, standard 15%/25% limits. To illustrate, consider the following examples. Employer M maintains an ESOP qualifying under Code section 4975. The ESOP enters into a loan, guaranteed by employer M, which is used to purchase se-

290. *Id.* § 54.4975-7(b)(7).

291. *Id.* § 54.4975-11(a)(7)(i), T.D. 7506, 1977-2 C.B. 449, amended by T.D. 7571, 1979-1 C.B. 368.

292. *Id.* § 54.4975-11(c).

293. *Id.* § 54.4975-11(a)(7)(ii).

294. I.R.C. § 404(a)(10)(A) (West Supp. 1982).

295. *Id.*

296. *Id.* § 404(a)(10)(B).

curities of employer M. All contributions to the ESOP are within the annual addition limits of section 415 of the Code. Contributions applied to the loan principal equal 20% of covered employees' compensation for taxable year Y. Applying the statute literally, employer M can also, for taxable year Y, contribute to the ESOP up to the lesser of (1) an additional 15% of compensation or (2) the extra amount allowed under the annual addition limits of Code section 415.²⁹⁷

Furthermore, assume employer M, in addition to maintaining and contributing to the ESOP, also maintains a defined benefit pension plan. Again, a literal reading of the statute indicates that employer M can contribute, for taxable year Y, to the defined benefit pension plan up to the lesser of (1) the amount allowed for deduction purposes under Code section 404(a)(1), the deduction limit for pension plans, or (2) the amount allowed under the limits of Code section 415.²⁹⁸

Another restriction on contributions to leveraged ESOPs, which restriction has been somewhat eased by ERTA, concerns the annual addition which can be made on behalf of any participant's account under all of an employer's defined contribution plans (including a stock bonus plan). An annual addition made on behalf of a participant includes (1) all employer contributions made for such year to his or her account, (2) forfeitures of other participants allocated for such year to the account and (3) the lesser of the participant's own nondeductible contributions for such year in excess of 6% of his or her compensation for such year or one-half of his or her nondeductible contributions for such year.²⁹⁹

The maximum annual addition which can be made to an employer's defined contribution plans on behalf of a participant is the lesser of (1) 25% of the participant's compensation for such year or (2) a dollar amount, \$45,475 for 1982 but only \$30,000 for 1983,³⁰⁰ to be adjusted again in 1986 and thereafter by the IRS for cost-of-living increases.³⁰¹ A special dollar limit, however, applies to a leveraged ESOP under which no more than one-third of employer contributions in a year are allocated to officers, employees

297. See *infra* notes 302-16 and accompanying text.

298. *Id.*

299. I.R.C. § 415(c)(2) (West Supp. 1982).

300. IRS News Release, IR-82-18, 4 PENS. & PROFIT SHARING (P-H) ¶ 107,409 (Feb. 3, 1982); Tax Equity Act § 235.

301. I.R.C. § 415(d) (1976), amended by Tax Equity Act § 235.

owning more than 10% of the employer's stock (without regard to stock held in the ESOP), or employees earning twice the dollar limit on annual additions.³⁰² This special dollar limit is the sum of (1) the normal dollar limit and (2) the lesser of the normal dollar limit or the amount of employer securities contributed to the ESOP.³⁰³ An ESOP able to use the special rule, therefore, will have an annual addition limit equal to the lesser of (1) 25% of the applicable participant's compensation for the subject year or (2) twice the normal dollar amount limit (\$60,000 (2 × \$30,000) for 1983).

IRS regulations provide that, except in certain limited situations, a defined contribution plan will not be a qualified plan under sections 401(a) and 501(a) of the Code if an annual addition made on behalf of a participant exceeds the limits applicable to such participant.³⁰⁴ This rule does not apply, however, if an annual addition limit is exceeded because of an allocation of forfeitures, a reasonable error in estimating a participant's annual compensation, or other limited circumstances which the IRS finds justify relief. In such cases, the excess annual addition may be either: (1) allocated to other participants or, if such is not possible because of the Code section 415 limits, held in suspense and allocated among all participants in the next year; or (2) held in suspense and used to reduce employer contributions for either the subject participant or all participants in the next and later years.³⁰⁵ If amounts are held in suspense and thereby not allocated until a later plan year, additional employer contributions may not be made until the suspense amount is allocated.³⁰⁶ If a contribution is made by reason of a mistake of fact, an employer contribution, in certain cases, may be returned to the employer.³⁰⁷ Furthermore, special rules apply to mistakes of fact or law for multi-employer plans.³⁰⁸

Employer contributions with regard to leveraged ESOPs must

302. I.R.C. § 415(c)(6)(A) (1976).

303. *Id.*

304. Treas. Reg. § 1.415-1(a)(2) (1980).

305. *Id.* §§ 1.415-6(b)(6)(i), (ii).

306. *Id.* § 1.415-6(b)(6)(i). Section 235 of the Tax Equity Act reduces the otherwise deductible contributions by the amount of contribution above the § 415 limits. This change is effective for years ending after July 1, 1982 for plans in existence on that date and is effective immediately for plans created thereafter.

307. ERISA § 403(c)(2)(A) (codified at 29 U.S.C. § 1103(c)(2)(A)); Rev. Rul. 77-200, 1977-1 C.B. 98.

308. ERISA § 403(c)(2)(A)(ii) (codified at 29 U.S.C. § 1103(c)(2)(A)(ii)).

be sufficient to meet the inflexible principal and interest payments on the subject loan. The "relief" situations described above may, therefore, not be helpful if the loan payments are set at such an amount as may be likely to exceed annual addition limits for certain of the participants. Employer contributions exceeding deductible limits will not disqualify a plan, and the excess contributions can generally be deducted in later years. However, employer contributions exceeding annual addition limits may, in many cases, disqualify a plan.

ERTA section 333(b), in amending Code section 415(c), provides a special rule for annual additions relating to leveraged ESOPs. The rule applies, however, only if no more than one-third of the employer contributions to the ESOP, which contributions are applied to the payment of principal and interest on a loan incurred to purchase employer securities and are deductible under new Code section 404(a)(10), are allocated to the group of employees consisting of officers, shareholders owning more than 10% of the employer's stock, excluding stock held in the ESOP, and employees earning at least twice the dollar limit on annual additions (\$90,950 for 1982 and \$60,000 for 1983).³⁰⁹ This rule is effective for taxable years beginning after December 31, 1981.³¹⁰

If the special rule is applicable, neither forfeitures of employer securities acquired with the proceeds of the loan nor employer contributions applied to interest payments on the loan will be subject to the Code section 415 limits.³¹¹ Hence, if a loan is incurred by the ESOP for the purpose of acquiring employer securities, with respect to employer contributions and forfeitures related to the loan, only the employer contributions applied to payment of loan principal will be deemed part of an annual addition, thereby subject to Code section 415 limits. Therefore, loans should be structured to provide for a fixed amount of loan principal to be paid back when each loan payment is due, even if the total periodic payments for principal and interest would be unequal. This would allow ESOPs meeting the requirements for the special rule to ensure more easily that the annual addition limits are not exceeded.

Code section 415 also limits the aggregate annual addition and projected retirement benefit applicable to any single participant

309. I.R.C. § 415(c)(6)(C) (West Supp. 1982).

310. ERTA § 333(b)(2).

311. I.R.C. § 415(c)(6)(C) (West Supp. 1982).

under all of an employer's defined contribution and defined benefit pension plans. This limit provides that the sum of the participant's defined contribution and defined benefit plan fractions, as of the end of any plan year, cannot exceed 1.4.³¹² The 1982 Tax Equity Act reduces this sum in the future in certain cases. The defined contribution plan fraction generally has a numerator equal to all the annual additions made to the end of the subject year for the participant under the employer's defined contribution plans, and a denominator equal to the maximum annual additions that could have been made to a defined contribution plan to the end of the year on behalf of the participant.³¹³ The defined benefit plan fraction generally has a numerator equal to the participant's projected retirement benefit as of the end of the subject year under the employer's defined benefit plans, and a denominator equal to the maximum projected retirement benefit allowed for the participant as of the end of the year under Code section 415(b).³¹⁴

The special rule provided for certain leveraged ESOPs by ERTA section 333(b), is also relevant here.³¹⁵ Where the special rule applies, forfeitures of employer securities acquired by a loan and deductible employer contributions applied to the payment of interest on the loan are not subject to the above "1.4 rule" limits.³¹⁶

G. *Qualified Bond Purchase Plan Changes*

Section 405(d) of the Code provides that distribution of a qualified bond from a qualified bond purchase plan described in Code section 405(a), or from a qualified profit sharing, stock bonus, or pension plan described in Code sections 401(a) and 501(a), is not taxable. Rather, the proceeds are taxable upon redemption of the bond.³¹⁷ ERTA section 313(a), in amending Code section 405(d), provides that, if a qualified bond is redeemed, any portion of the proceeds of the qualified bond in excess of the bond's basis (i.e., nondeductible employee contributions) rolled over to an IRA established for the benefit of the individual redeeming the bond within sixty days of the redemption, will not be included in the

312. I.R.C. § 415(e)(1) (1976).

313. I.R.C. § 415(e)(3) (1976).

314. *Id.* § 415(e)(2).

315. *See supra* notes 309-11 and accompanying text.

316. *See supra* note 309.

317. I.R.C. § 405(d)(1) (West Supp. 1982).

individual's income for purposes of determining federal income tax.³¹⁸ Such amounts will not be taxable until distributed from the IRA. This new provision, therefore, adds a rollover option for qualified bonds distributed from a qualified bond purchase plan or a qualified profit sharing, stock bonus or pension plan. The rule only applies to redemptions made after August 13, 1981, the date of enactment of ERTA, in taxable years also ending after that date.³¹⁹

A "qualified bond" refers to a bond issued under the Second Liberty Bond Act, which (1) provides for payment of interest only upon redemption, (2) may be purchased only in the name of an individual, (3) ceases to bear interest no later than five years after the subject individual's death, (4) may be redeemed before death by the subject individual only if he or she is age fifty-nine and one-half or older or disabled, and (5) is nontransferable.³²⁰

H. *General Qualified Plan and IRA Changes*

1. *Constructive Receipt Rule Eliminated*

Prior to ERTA, amounts distributed or made available from a tax qualified profit sharing, stock bonus, or pension plan were taxable.³²¹ The phrase "or made available" created a constructive receipt rule. An employee or beneficiary with an unfettered right to a plan amount was taxable on such amount.

Pursuant to Revenue Ruling 55-423,³²² the IRS previously permitted two restrictions on available plan amounts to restrict their taxation: (1) a penalty; or (2) a prior irrevocable election to defer receipt until a later specific event (such as separation from service), or for a substantial period of time (such as ten years).³²³ Some plans created other restrictions the purpose of which was to prevent uncontrolled employee access to funds. For example, one such restriction required that distribution be made only upon the consent of the plan's administrative committee. Often, however, this committee merely rubber-stamped the request of an employee

318. *Id.* § 405(d)(3).

319. ERTA § 313(c).

320. I.R.C. § 405(b) (1976 & Supp. IV 1980). The Department of the Treasury announced on May 27, 1982 that it was discontinuing offerings of such retirement bonds. [1982] 4 PENS. & PROFIT SHARING (P-H) ¶ 120,156.

321. I.R.C. § 402(a)(1) (1976).

322. Rev. Rul. 55-423, 1955-1 C.B. 41.

323. The IRS never expressly permitted a shorter deferral period. See IRS Private Letter Ruling 8010104 (December 14, 1979).

or beneficiary. Committee approval, therefore, often had no actual substance.

ERTA section 314(c) eliminates the phrase "or made available" from Code section 402(a)(1) and, thereby, eliminates constructive receipt as a federal income tax issue on qualified plan amounts. This provision is effective for taxable years beginning after December 31, 1981.³²⁴ The elimination of the constructive receipt rule should affect qualified plans in two important situations: the ability to receive plan amounts during employment, and the deferral of receipt after separation from service. The discussion below concerning these effects is subject to IRS regulations concerning the elimination of the constructive receipt rule. A go-slow approach on plan changes, therefore, may be prudent until regulations are issued.

The first major issue stemming from the elimination of the constructive receipt rule concerns distributions during employment. At first glance, the elimination of the rule would allow employees to withdraw vested amounts at will, similar to a savings account. There are general restrictions, however, on distributions from qualified plans that will restrict the above savings account approach. Under IRS regulations and rulings, a defined benefit or money purchase pension plan may not make distributions, except of incidental death or disability benefits, until an employee separates from service or attains normal retirement age.³²⁵ IRS regulations also require that a profit sharing or stock bonus plan not make distributions until either the employee attains a stated age, or the occurrence of an event such as layoff, illness, disability, retirement, death or separation of employment or after a certain number of years.³²⁶ Revenue Ruling 54-231³²⁷ has interpreted this number of years to be at least two years.

Moreover, if a profit sharing or stock bonus plan allows distributions during employment, the continued qualification of the plan may be endangered; if lower-paid employees withdraw most amounts to their credit, except for amounts held less than two years, and highly-paid employees keep most amounts in the plan, the IRS might rule that the benefits of the plan discriminate in

324. ERTA § 314(c)(2).

325. Treas. Reg. § 1.401-1(b)(1)(i), 1964-1 (Part 1) C.B. 144; Rev. Rul. 56-693, 1956-2 C.B. 282; IRS Publication 778, Part 2(o), 4 PENS. & PROFIT SHARING (P-H) ¶ 107,070 (February, 1972).

326. Treas. Reg. § 1.401-1(b)(1)(ii), (iii), 1956-2 C.B. 219.

327. Rev. Rul. 54-231, 1954-1 C.B. 150.

favor of the highly-compensated and that they violate Code section 401(a)(4). The IRS may also promulgate regulations requiring that, in order for the plan to retain its qualified status, the deferral percentage for lower-paid employees be close to the deferral percentage for highly-compensated employees. These requirements would be similar to those for deferral percentages for cash or deferred profit sharing and stock bonus plans under section 401(k) of the Code.³²⁸ A savings account approach allowing withdrawals during employment would increase administrative costs for plans covering a substantial number of employees and would also, perhaps, restrict the type of investments in which the plan may engage.

The second major issue stemming from the elimination of the constructive receipt rule concerns the deferral of plan benefit payments for employees terminating employment. Prior to ERTA, a terminating employee technically created a risk of constructive receipt if such employee elected, by action or inaction, not to have the benefit due him or her under the plan paid until election, which in some plans could occur at any later time. This situation frequently arose in the early retirement context. The elimination of the constructive receipt rule, however, now clearly allows an employee to defer payment of his or her retirement benefit past his or her retirement or separation from service without fear of immediate taxation.

IRS regulations indicate that distributions can be deferred (even past retirement and normal retirement age) if the deferral and eventual planned distribution will not cause the benefits payable on the employee's death to be more than incidental to the total benefit due the employee.³²⁹ This "incidental" restriction appears to be the only current limitation on the deferral of payment. For years beginning after 1983, for employees who are not key employees in a top-heavy plan (i.e., a plan benefiting mainly key employees), distribution cannot be deferred beyond the later of the employee's attainment of age seventy and one-half or the employee's actual retirement. For key employees, distribution cannot be deferred beyond the employee's attainment of age seventy and one half. Distribution is required to be paid over a period not in excess of the lives or the joint life and last survivor expectancy of the employee and his or her spouse.³³⁰ It is possible the "inci-

328. I.R.C. § 401(k)(3) (Supp. IV 1980).

329. Treas. Reg. § 1.401(a)-14(b)(3) (1976).

330. Tax Equity Act § 242.

dental" rule will become unimportant once these new rules take effect.

Under current IRS rulings, there are two rules used in defining death benefit protection as incidental. The first is the "50% rule."³³¹ If the present value of the payments that will be paid to the employee during his or her lifetime is more than 50% of the present value of the total payouts that will be made under the distribution option to the employee and his or her beneficiaries, the payments payable on the employees's death will be deemed incidental. Where annuity contracts are purchased by a plan for purposes of making distribution payouts, or, in a defined benefit pension plan, where annuity payouts, based on actuarial assumptions, are provided under the plan, the present value of benefits payable to the employee or the employee and his or her beneficiaries may be ascertained by reference to the cost of, or funding required for, a single life annuity for the employee and the cost of, or funding required for, the total annuity contract, or payout, respectively. Where annuity contracts are not used to provide the distribution payout, it must appear certain that at least 50% of the plan amount due the employee upon his or her termination and any earnings thereon be distributable within the employee's life expectancy, generally on at least a minimally periodic schedule.³³² However, where earnings fluctuate from year to year, as is common in defined contribution plans, it may be extremely difficult to guarantee that 50% of the retirement amount and earnings will be paid within the employee's life expectancy. This is especially true where the distribution scheme permits a payout period beyond the life expectancy. Therefore, such plans sometimes provide that all earnings made on the amount due the employee at his or her termination of employment will be paid annually to him or her.

The second rule delineating the "incidental" test arises out of Code provisions and IRS regulations applicable to Keogh plans. Distributions from a Keogh plan must begin no later than the end of the employee's taxable year in which age seventy and one-half is attained (or, in the case of an employee other than an owner-employee, the last day of the taxable year in which the employee terminates employment) and may be paid over any period not exceeding the lives or the joint life and last survivor expectancy of the employee and his or her spouse.³³³ Furthermore, where annu-

331. Rev. Rul. 72-241, 1972-1 C.B. 108.

332. *Id.*

333. I.R.C. § 401(a)(9) (1976); Treas. Reg. § 1.401-11(e), T.D. 6675, 1963-2 C.B. 151.

ity contracts are not purchased, distributions from a Keogh plan over the above period must be made at least annually, with each year's distribution being at least equal to the quotient obtained by dividing the entire interest of the employee under the plan at the time the distribution is made by the employee's life expectancy or the joint life and last survivor expectancy of the employee and his or her spouse, whichever is applicable.³³⁴ Revenue Ruling 72-240³³⁵ states that a corporate plan may use the same distribution rules which are appropriate for a Keogh plan. These appear to be the rules for use after 1983 in determining whether benefits paid upon death under the plan are more than incidental, except that the owner-employee rules will apply to any key employee under a top-heavy plan, whether corporate or Keogh.³³⁶

A final issue remaining with respect to the elimination of the constructive receipt rule is its effect on the federal estate tax on amounts held in a plan at an employee's election but not distributed to such employee prior to death. Liberalizing rules on the right of employees to withdraw amounts from their accounts may create a danger that such amounts will be included in an employee's gross estate if death occurs prior to withdrawal.³³⁷ Code sections 2039(c) and (f) provide that annuities, or other payments not qualifying as lump sum distributions, which are attributable to employer contributions and paid to a beneficiary (other than the executor) of a deceased employee under a qualified profit sharing, stock bonus, or pension plan will be excluded from the decedent's gross estate for federal estate tax purposes (although after 1982 this exclusion is limited to \$100,000).³³⁸ In the past, the IRS has taken the position that if the deceased employee had constructive receipt of all such plan amounts prior to death, then any such amounts paid from the plan to the decedent's beneficiary after his or her death would not be considered as paid under a qualified plan and hence will not be excludible to any extent from the decedent's gross estate.

Example (4) under Treasury Regulation section 20.2039-2(b),³³⁹ for instance, concerns a situation in which an employee

334. Treas. Reg. § 1.401-11(e)(5), T.D. 6675, 1963-2 C.B. 151.

335. 1972-1 C.B. 108.

336. See *supra* note 330 and accompanying text.

337. This is not a problem because of the changes in other estate tax laws promulgated under ERTA. See *infra* notes 342-46 and accompanying text.

338. Tax Equity Act § 245.

339. T.D. 6296, 1958-2 C.B. 432.

had the right upon reaching retirement age to take all amounts in the employee's qualified plan account in a lump sum, or to apply all such amounts to the purchase of a joint and survivor annuity, or to leave all such amounts with the plan's trustee under an arrangement whereby interest would be paid on such amounts during the employee's lifetime with the principal going to a beneficiary upon the employee's death. Furthermore, if the interest option were chosen, the employee retained the right to take all amounts in a lump sum. In the Example, the employee chose the interest option and died without exercising the right to take all amounts in a lump sum. It was concluded that the plan payments to the employee's beneficiary were not paid under the plan and, as a result, such payments were included in the employee's gross estate. Therefore, the current rule is that if an employee is in constructive receipt of any amount held in a qualified plan for such employee's benefit, such amounts will be includible in his or her gross estate even if the employee dies before actually receiving such amount from the plan.

Revenue Ruling 77-139 noted that the constructive receipt rule for federal estate tax purposes was implicitly tied to the constructive receipt rule previously applicable to federal income taxes.³⁴⁰ It remains to be seen whether the IRS will eliminate the constructive receipt rule for federal estate tax purposes as ERTA has done in the federal income tax area, thereby holding that all annuities and other non-lump sum distributions payable to a beneficiary (other than an executor) of a deceased employee from a qualified plan are excludible to at least some extent from the decedent's estate.³⁴¹

2. *Changes in Estate Tax Rules and Income Tax Rates Affect Qualified Plan Distributions*

Changes made by ERTA in the estate and gift tax area, partic-

340. Rev. Rul. 77-139, 1977-1 C.B. 278.

341. It should be noted that amounts held in IRAs are available at the will of the owner of the IRA without any substantive restrictions once the owner has either attained age 59 1/2 or become disabled. I.R.C. § 408(a)(4), (f)(1) (1976). I.R.C. § 2039(e) (Supp. IV 1980), moreover, provides that annuities or other arrangements payable (generally over at least 36 months) to a beneficiary (other than the executor) of a deceased owner "under" an IRA will be excludible from the owner's gross estate. Despite this essentially "constructive receipt," it appears that the IRS has never attempted to hold that amounts paid from the IRA after the owner's death to a beneficiary (other than the executor) were includible in the gross estate of the owner. The Staff of the Joint Committee on Taxation has also stated that the elimination of the "constructive receipt" rule should not affect the estate tax exclusion otherwise applicable. STAFF EXPLANATION, *supra* note 36, at 215.

ularly the increased credit against such taxes,³⁴² have made estate and gift taxes less of a concern for many employees. With respect to distributions upon an employee's death from a tax qualified profit sharing, stock bonus, or pension plan, there is a trade-off between income and estate tax results. If a lump sum distribution is made to the employee's beneficiary, the distribution is taxed for federal income tax purposes, pursuant to Code sections 402(a) and (e), as ordinary income. Favorable capital gains treatment, however, may alternatively be available if the employee actively participated in the plan prior to 1974. Ten-year forward averaging treatment may similarly be available if the employee participated for at least five years in the plan. However, if a lump sum distribution is made, and these more favorable tax treatments are used on the income tax side, sections 2039(c) and (f) of the Code provide that the distribution will be included in the employee's gross estate for purposes of determining the federal estate tax.

In contrast, if a lump sum distribution is not made, or if the beneficiary (if other than the executor) irrevocably elects not to employ capital gain or ten-year forward averaging treatment, the distribution is taxed as ordinary income for federal income tax purposes with no capital gain or ten-year forward averaging treatment possible.³⁴³ In this case, sections 2039(c) and (f) of the Internal Revenue Code will exclude the distribution from the employee's gross estate in determining federal estate tax. After 1982, however, this exclusion will not exceed \$100,000.³⁴⁴

A lump sum distribution is defined in Code section 402(e)(4) as the distribution within one taxable year to an employee or his or her beneficiary of the entire balance in the plan to the credit of the employee, which becomes payable, because of the employee's death or for some other specified reason. To the extent ERTA and the 1982 Tax Equity Act have made avoidance of estate tax less important, there would, in many cases, be a corresponding increase in the attractiveness of taking payment in the form of a lump sum distribution and utilizing the favorable income tax treatments.

Finally, beginning with taxable years after December 31, 1981, ERTA reduces the individual income tax rates.³⁴⁵ Indirectly, this change will reduce the rates applicable to ten-year forward aver-

342. ERTA § 401(a), (b) (amending I.R.C. §§ 2010, 2505).

343. I.R.C. § 402(a)(1) (West Supp. 1982).

344. Tax Equity Act § 245.

345. ERTA § 101 (amending I.R.C. § 1).

aging,³⁴⁶ thereby making the use of that tax advantage even more attractive.

3. *Investments in Collectibles Treated as Distributions*

ERTA section 314(b), in adding Code section 408(n),³⁴⁷ provides that an investment in a collectible, by an IRA or an individually-directed account under a tax qualified profit sharing, stock bonus, or pension plan, will be treated as an account distribution equal in amount to the collectible's cost. The benefited individual, therefore, in most cases, will include this investment in his or her gross income for federal income tax purposes.

Code section 408(n)(2) defines a collectible as (1) any work of art, (2) any rug or antique, (3) any metal or gem, (4) any stamp or coin, (5) any alcoholic beverage, or (6) any other tangible personal property specified by the IRS for these purposes.³⁴⁸ The primary stated purpose behind the legislation is to promote investments in productive capital.³⁴⁹

There is some question as to what is included as an "individually-directed" qualified plan account. For instance, in a qualified plan sponsored by a closely held corporation, the shareholder-employees are often the plan trustees responsible for investing all employee accounts. The new provision may apply to the extent plan trustees invest their own employee accounts in collectibles. The Staff of the Joint Committee on Taxation appears to indicate, however, that the prohibition on acquiring collectibles should not apply solely because the participant is a fiduciary under the plan and is, therefore, involved in directing plan investments.³⁵⁰ It is likely, however, that there is a prohibition against a participant's investing, in his or her individual rather than fiduciary capacity, plan accounts in funds which invest in collectibles. Such prohibition exists even if the participant does not direct the specific type

346. I.R.C. § 402(e)(1) (1976).

347. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would redesignate this provision as I.R.C. § 408(m).

348. I.R.C. § 408(n)(2) (West Supp. 1982). The Staff of the Joint Committee on Taxation has indicated the law does not intend to affect the ability to invest in regulated investment companies (such as a mutual fund or a closed-end investment company), even if such regulated investment company acquires collectibles. STAFF EXPLANATION, *supra* note 36, at 213.

349. H.R. REP. No. 201, 97th Cong., 1st Sess. 143 (1981). STAFF EXPLANATION, *supra* note 36, at 212 (which also indicates a concern with personal use of collectibles being a reason for the law).

350. *Id.* at 212.

of collectible to be acquired.³⁵¹

This new provision is effective only to property acquired after December 31, 1981 in taxable years ending after such date.³⁵² Therefore, collectibles already acquired as investments prior to December 31, 1981 may be retained in the account. However, the "prohibited transaction" provisions of Code section 4975 or the distribution tax provisions of Code section 402 may apply to the use by a disqualified person for his or her own (non-investment) interest of the assets of the plan, including previously-acquired collectibles. For instance, a person who individually directs his or her IRA or plan account to invest in a painting, and then places such painting in his or her office may be either subject to an excise tax under Code section 4975, or taxed on a "deemed" distribution of his or her IRA or plan account, or both.

II. INCENTIVE STOCK OPTIONS

A. *History*

In past years, Congress has provided for types of stock options under which the grant and exercise of the option would not be taxed to the employee. The most important of these options were called "restricted stock options" under Code section 424 and "qualified stock options" under Code section 422. In order to benefit from these options, an employee had to exercise them no later than May 21, 1981.³⁵³ Section 251(a) of ERTA, in adding section 422A to the Code, provides for "incentive stock options" which serve to revive the old "restricted" and "qualified" stock option rules.³⁵⁴ The purpose of this change is to continue allowing employers to motivate key employees to further the future growth of the employer by allowing such employees to share in that growth.³⁵⁵ Incentive stock options will, therefore, have the greatest effect on high-growth companies.

B. *Tax Consequences*

Under the new tax law, the grant of an incentive stock option will have no tax consequences to either the optionee or the em-

351. IRS Notice 82-13 (Q. and A. III-5), 1982-19 I.R.B. 15.

352. ERTA § 314(b)(2).

353. I.R.C. §§ 422(b), (c)(7), 424(b), (c)(3) (1976).

354. H.R. REP. NO. 215 [Conference Report], 97th Cong., 1st Sess. 233-35 (1981).

355. S. REP. NO. 144, 97th Cong., 1st Sess. 98-99 (1981); H.R. REP. NO. 201, 97th Cong., 1st Sess. 260-61 (1981).

ployer.³⁵⁶ Furthermore, the exercise of an incentive stock option will not be a taxable event for the optionee, although the employer will not be allowed to obtain any deduction with respect to such exercise.³⁵⁷ To obtain these latter two tax effects, however, two requirements must be met. First, no disposition of the stock exercised under the option may be made by the optionee either (1) within two years from the date of the grant of the option, or (2) within one year after the transfer of such stock to the optionee.³⁵⁸ Second, at all times from the granting of the option until at least three months before the exercise of the option, the optionee must have been an employee of (1) the corporation granting the option; (2) a parent or subsidiary corporation to such corporation; or (3) another corporation (or parent or subsidiary corporation thereof) assuming the option by reason of a corporate merger, consolidation, or the like.³⁵⁹

As a special rule applicable only to incentive stock options, if an optionee of an incentive stock option terminates his or her employment by reason of a disability, such optionee may exercise such option at any time within one year of the termination and still be deemed to have met this employment restriction.³⁶⁰ The employment restriction, however, need not be expressly stated in the terms of the option. In fact, the option can allow exercise even after expiration of three months following termination of employment.³⁶¹ However, favorable tax treatment will only result if exercise occurs within three months of termination of employment (except where termination is due to disability or death).³⁶²

The above restrictions on holding period and employment do not apply, however, to the exercise of an incentive stock option

356. S. REP. NO. 144, 97th Cong., 1st Sess. 99 (1981); H.R. REP. NO. 201, 97th Cong., 1st Sess. 261 (1981).

357. I.R.C. § 421(a) (West Supp. 1982).

358. *Id.* § 422A(a)(1). This requirement is the same as the final rules applicable to restricted stock options. I.R.C. § 424(a)(1) (Supp. IV 1980). Qualified stock options, on the other hand, restricted the favorable tax results to cases where no disposition occurred within three years of the transfer of such stock. I.R.C. § 422(a)(1) (1976).

359. I.R.C. § 422A(a)(2) (West Supp. 1982). This requirement is essentially the same as had applied to restricted and qualified stock options. *See* I.R.C. §§ 424(a)(2), 422(a)(2) (1976).

360. I.R.C. § 422A(c)(9) (West Supp. 1982). For this purpose, a disability exists if an individual is unable to engage in any substantial gainful activity by reason of any medically determinable physical or mental impairment which can be expected to result in death or which has lasted or can be expected to last for a continuous period of not less than 12 months. I.R.C. § 105(d)(4) (Supp. IV 1980).

361. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 23) (1981).

362. *Id.*

either by the estate of the optionee or by a person to whom the option devolves by bequest or inheritance on the optionee's death.³⁶³ Old IRS regulations indicate that this rule only applies if the optionee had still been able to meet the employment restriction at the time of his or her death.³⁶⁴

If shares transferred to an optionee under an incentive stock option are disposed of before the expiration of the holding period restrictions set forth above, the optionee must include as compensation income the difference between the fair market value of the shares upon exercise and the option price.³⁶⁵ The employer obtains a corresponding deduction.³⁶⁶ Any excess of the amount received on disposition over the fair market value of the shares at the time of exercise of the option will be short-term or long-term capital gain, depending on the length of time held from exercise of the option to the disposition.

Section 83 of the Code provides that shares acquired pursuant to the exercise of a nonqualified stock option by an optionee who is subject to the prohibition against short-swing profits imposed by section 16(b) of the Securities Exchange Act of 1934³⁶⁷ are treated as being nontransferable and subject to a substantial risk of forfeiture during a time period of probably six months following receipt of the shares. It is unclear under the current provisions of the Code and the regulations thereunder whether this result will also apply to shares acquired by such an optionee pursuant to exercise of an incentive stock option if such shares are sold, exchanged, or otherwise disposed of prior to the expiration of the holding period restrictions.³⁶⁸ If such result is held to apply, and if an optionee

363. I.R.C. § 421(c) (West Supp. 1982).

364. Treas. Reg. § 1.421-8(c)(1) (1966).

365. I.R.C. § 421(b) (1976); Treas. Reg. § 1.421-8(b)(1) (1966); Treas. Reg. § 1.83-7 (1978).

366. *Id.*

367. 15 U.S.C. § 78p(b) (1976). Generally, employees who are directors, officers, or ten percent or more shareholders of an employer are subject to the restrictions of Section 16(b) of the Securities Exchange Act of 1934.

368. Read literally, I.R.C. § 83 (1976), which contains this special rule, should not apply to incentive stock options the shares of which are disposed of prior to expiration of the "holding period" requirements, inasmuch as § 83(e)(1) states that it is not applicable to a transaction to which I.R.C. § 421 applies. Section 421(b) does indeed provide a rule as to the tax treatment of a transfer of shares pursuant to an incentive stock option where the "holding period" restrictions do not apply, namely, that the income to the optionee and the deduction to the employer will be reported for the taxable year of the disposition of the shares. Still, under old regulations dealing with prior kinds of statutory options, it was generally considered that a disposition of shares prior to the expiration of any applicable "holding period" restrictions caused the option to be treated as a nonqualified option and it

subject to the short-swing profits restrictions disposes of the shares transferred to him or her under the incentive stock option before the expiration of the holding period restrictions, such optionee will have to include as compensation income in the taxable year during which such disposition occurs the difference between the fair market value of the shares on the expiration of the six-month period following receipt of such shares (rather than the fair market value of the shares upon exercise) and the option price, and the employer will obtain a corresponding deduction for that difference. Resolution of this issue will require further legislation, administrative action, or judicial decision. It does seem clear, however, that the failure of an optionee to exercise an incentive stock option within the employment restrictions noted above will cause the option to be treated as a nonqualified option subject to Code section 83, and thereby the special rule for optionees subject to the short-swing profits restrictions should apply in such case.³⁶⁹

As a special rule, it is provided that if (1) the optionee disposes of such shares within the two-year period beginning on the grant of the option, and (2) such disposition is a sale or exchange to which a loss, if sustained, would be recognized to the optionee (i.e., for instance, it is not a sale between related parties under section 267 of the Code), then the amount included as compensation income to the optionee and the corresponding deduction to the employer will not exceed the excess of the sale price over the option price.³⁷⁰ This special rule, however, only applies if disposition is made within two years of the grant of the option and not in cases where the holding period requirement is violated solely by reason of disposition within one year of the option's exercise.³⁷¹ Legislation may correct this point.³⁷²

If an option which does not qualify as an incentive stock option is granted to an employee, and is, therefore, a nonqualified option, the tax consequences of the granting of such option are

was generally stated that § 421 did not apply to that situation. *See* Treas. Reg. § 1.421-6(a)(1), 1966-2 C.B. 131; Treas. Reg. § 1.421-8 (1966).

369. This result occurs since no provision of § 421 does apply if such "employment" restrictions are violated and thus § 83 without question has applicability here.

370. I.R.C. § 422A(c)(2) (West Supp. 1982).

371. In this regard, the Staff of the Joint Committee on Taxation has indicated that this special rule applies if the disposition of shares is made either within two years of the grant of the option or within one year of the option's exercise. STAFF EXPLANATION, *supra* note 36, at 159 n.3. This rule is similar to the rule applied to qualified stock options. I.R.C. § 422(c)(4) (1976).

372. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would apply the special rule if *either* of the "holding period" restrictions is violated.

determined under Code section 83, noted above, and Treasury Regulation section 1.83-7. Under these rules, if the nonqualified option at the time of grant has a readily ascertainable fair market value, at the time of the grant, the optionee reports as compensation income the excess of the fair market value of the option over the amount paid for the option and the employer obtains a corresponding deduction.³⁷³ Under such rules, however, if the nonqualified option at the time of grant does not have a readily ascertainable fair market value, in general (1) the optionee will, in the year when the option is exercised, include as compensation income the excess of the fair market value of the shares over the option price, and (2) the employer will at such time obtain a corresponding deduction.³⁷⁴ Special rules apply if the nonqualified option is granted to a corporate insider.³⁷⁵

C. Requirements of an Incentive Stock Option

An incentive stock option is an option granted to an individual for any reason connected with his or her employment by either a corporation, or its parent, or by a subsidiary corporation.³⁷⁶ The incentive stock option must meet all of the following requirements:

1. The option is granted pursuant to a plan which includes the aggregate number of shares which may be issued under options and the employees (or class of employees) eligible to receive options, and such plan is approved by the shareholders of the granting corporation within twelve months before or after the date it is adopted.³⁷⁷ Old IRS regulations under Code section 422 (as to qualified stock options) indicate that the class of employees eligible to receive options may be described as "key employees of the grantor corporation," "all salaried employees" of the grantor corporation and its subsidiaries, or "all employees of the corporation."³⁷⁸

As noted below,³⁷⁹ the terms of any plan must also include the limitation on the value of shares eligible for incentive stock op-

373. I.R.C. § 83(a) (1976); Treas. Reg. § 1.83-7(a) (1978).

374. *Id.*

375. *See infra* notes 507-13 and accompanying text.

376. I.R.C. § 422A(b) (West Supp. 1982).

377. *Id.* § 422A(b)(1). This requirement is the same as applied to qualified stock options. I.R.C. § 422(b)(1) (1976).

378. Treas. Reg. § 1.422-2(b)(3), T.D. 6887, 1966-2 C.B. 129.

379. *See infra* note 405 and accompanying text.

tions. It is unlikely, however, that this part of the plan will need direct shareholder approval. This conclusion is supported by two facts. First, the only provision dealing with incentive stock options which requires shareholder approval does not mention the value limitation.³⁸⁰ Second, temporary IRS regulations provide that if an existing plan is amended to add the value limitation, no new stockholder approval is required; the same treatment may reasonably be expected for newly-adopted incentive stock option plans.³⁸¹

2. The option must be granted within ten years from the earlier of: (1) the date of plan adoption; or (2) shareholder approval of the plan.³⁸² This is the same rule as applied to qualified stock options.³⁸³

3. The option may not be exercised after the expiration of ten years from the grant of the option.³⁸⁴ This is the same rule as applied to restricted stock options.³⁸⁵ Qualified stock options, however, had a five-year limitation on exercising an option after its grant.³⁸⁶

4. The option price, the price at which the shares subject to the option may be purchased, must not be less than the fair market value of the stock at the time the option is granted.³⁸⁷ This requirement is deemed met if a good faith effort was made by the employer corporation to equate the option price and the shares' fair market value, even if the option price turns out to be less than the fair market value.³⁸⁸

This requirement, including the good faith rule, generally follows the prior provisions as to qualified stock options³⁸⁹ with the exception that if a qualified stock option price was less than the fair market value of the shares at the time of the option grant, the optionee had to include as compensation income an amount equal to the lesser of (1) 150% of the difference between the option price and the fair market value of the shares at the time of the grant of

380. I.R.C. § 422A(b)(1) (West Supp. 1982).

381. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 31) (1981). *See also supra* note 371 at 162.

382. I.R.C. § 422A(b)(2) (West Supp. 1982).

383. I.R.C. § 422(b)(2) (1976).

384. I.R.C. § 422A(b)(3) (West Supp. 1982).

385. I.R.C. § 424(b)(4) (1976).

386. *Id.* § 422(b)(3).

387. I.R.C. § 422A(b)(4) (West Supp. 1982).

388. *Id.* § 422A(c)(1). *See also* S. REP. NO. 144, 97th Cong., 1st Sess. 100 (1981).

389. I.R.C. § 422(b)(4) (1976).

the option, or (2) the difference between the option price and the shares' fair market value at the time of exercise.³⁹⁰ The provisions relating to restricted stock options allowed the option price to be set as low as 85% of the fair market value of the shares at the time of the option grant, subject to special rules which are inapplicable to incentive stock options.³⁹¹

Regulations established pursuant to qualified stock options³⁹² give some indication what limited actions manifest good faith. In the case of a publicly held stock which was actively traded at the time of the option grant, good faith would be demonstrated by any reasonable method using market quotation. In the case of non-publicly traded stock, resort to completely independent and qualified experts in valuing stock will be required to show good faith.³⁹³

5. The option, by its terms, must not be transferable by the optionee other than by will or by the laws of descent and distribution and must be exercisable, during his or her lifetime, only by the optionee.³⁹⁴ This is the same rule as applied to restricted and qualified stock options.³⁹⁵

6. The optionee, at the time the option is granted, may not own stock possessing more than 10% of the total combined voting power of all stock of the granting corporation, unless the option price is set at an amount equal to at least 110% of the fair market value of the stock at the grant of the option, and the option, by its terms, is not exercisable after five years from the date of the grant of the option.³⁹⁶ The good faith relief applicable to the setting of an option price of at least 100% of the applicable stocks' fair market value has not been deemed applicable to the setting of these option prices at 110% of fair market value.

The 110% ownership limitation follows provisions pertaining to restricted stock options.³⁹⁷ The rules pertaining to qualified stock options prohibited the granting of options to employees who, immediately after the grant of the option, owned more than 5% of the voting power of the granting corporation—although this 5% limitation rose to 10% of the voting power for corporations

390. *Id.* § 422(c)(1).

391. *Id.* § 424(b)(1), (c)(1) (1976 & Supp. IV 1980).

392. Treas. Reg. § 1.422-2(e)(2)(ii), T.D. 6887, 1966-2 C.B. 129.

393. *Id.*

394. I.R.C. § 422A(b)(5) (West Supp. 1982).

395. I.R.C. §§ 424(b)(2), 422(b)(6) (1976).

396. I.R.C. §§ 422A(b)(6), 422A(c)(8) (West Supp. 1982).

397. I.R.C. § 424(b)(3) (1976).

with equity of less than two million dollars. Also, qualified stock options had no analogous "110% or five year" rule providing any relief as to such restrictions.³⁹⁸

7. The option by its terms is not exercisable while there is outstanding any prior incentive stock option of the employer corporation, its parent or subsidiary corporation, or a predecessor corporation of any of such corporations.³⁹⁹ For such purposes, an option is treated as outstanding until the option is exercised in full or expires by reason of a lapse of time under its original terms.⁴⁰⁰

As an example, employer M grants an incentive stock option to employee X which is exercisable at any time within ten years from the grant of the option. The fair market value of the stock of employer M declines and, therefore, there is little incentive to exercise the prior option. After five years from the date of the grant of the prior option, employer M grants a new incentive stock option to employee X at a price equal to the new lower value of employer M's stock. Employee X may not exercise the new incentive stock option at this time or at any time prior to the exercise of the prior option or the prior option's lapse, i.e., ten years following its grant. This rule may lead to employers issuing incentive stock options which are exercisable only for a period much shorter than the maximum ten-year period.

It is important to note that where an incentive stock option is granted in tandem with a stock appreciation right (SAR), exercise of the SAR will, for the purposes of the sequential exercise restriction, be considered an exercise-in-full of the option.⁴⁰¹ This provision of the temporary IRS regulations is subject, however, to the following five requirements: (1) the SAR expires no later than the expiration of the underlying incentive stock option; (2) the SAR is for no more than 100% of the difference between the option price of the incentive stock option and the fair market value of the stock at the time the SAR is exercised; (3) the SAR is transferable only when the underlying incentive stock option is transferable, and on the same conditions; (4) the SAR is exercisable only when the underlying incentive stock option is eligible to be exercised; and (5) the SAR may be exercised only when the market price of the stock subject to the underlying incentive stock option exceeds the price

398. *Id.* § 422(b)(7).

399. I.R.C. § 422A(b)(7) (West Supp. 1982).

400. *Id.* § 422A(c)(7).

401. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 39) (1981).

of the option.⁴⁰²

The restriction prohibiting the grant of an incentive stock option while a prior incentive stock option is outstanding generally follows similar rules previously applied to qualified stock options,⁴⁰³ with the exception that a qualified stock option for the same class of shares offered under all prior statutory options could be granted if its option price was equal to or higher than any prior statutory option.⁴⁰⁴

8. As a condition to any incentive stock option granted to an employee in a calendar year after 1980, the aggregate fair market value (determined at the time the option is granted) of stock for which incentive stock options may be granted by the employer corporation or its parent or subsidiary corporations cannot exceed the sum of (1) \$100,000 and (2) any unused limit carryovers to such year.⁴⁰⁵ "Unused limit carryovers" are determined as follows: if, in any calendar year after 1980, \$100,000 exceeds the aggregate fair market value of stock for which incentive stock options are granted to an employee in a calendar year by the employer corporation or its parent or subsidiary corporations, then one-half of such excess may be carried forward as unused limit carryover to the three immediately succeeding calendar years. This amount is so carried forward until it is exhausted.⁴⁰⁶ Incentive stock options granted to one employee in a calendar year will be treated as first exhausting the base \$100,000 limitation for such calendar year, and then shall be treated as exhausting unused limit carryovers of the employee to such calendar year in the order of the calendar years in which the unused limit carryovers arose.⁴⁰⁷ This \$100,000 and unused limit carryover restriction must be expressly stated in the plan. Also, IRS temporary regulations⁴⁰⁸ state that a good faith attempt to comply with the \$100,000 and unused limit carryover restriction will be deemed compliance with the restriction.

For example, employer M establishes a new incentive stock option plan in 1981. Thirty thousand dollars of incentive stock

402. *Id.* STAFF EXPLANATION, *supra* note 36, at 162.

403. I.R.C. § 422(b)(5) (1976).

404. *Id.* § 422(c)(6).

405. I.R.C. § 422A(b)(8) (West Supp. 1982). The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would allow a "good faith" rule to apply in ascertaining whether incentive stock options exceed this restriction.

406. I.R.C. § 422A(c)(4) (West Supp. 1982).

407. *Id.* § 422A(c)(4)(c).

408. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 24) (1981).

options are granted to employee X, while a member of the class of employees eligible for an incentive stock option award, in each of the years 1981, 1982, and 1983. For 1984, employee X may be granted incentive stock options by employer M or its parent or subsidiary corporations for stock with an aggregate fair market value of \$205,000 (the base \$100,000 plus \$105,000 unused limit carryovers from 1981, 1982, and 1983 (\$35,000 (one-half of \$70,000) in carryovers from each of such years)). In 1984, employee X is granted incentive stock options for stock with an aggregate fair market value of \$125,000, which is deemed to exhaust the base \$100,000 limitation for 1984 and \$25,000 of the remaining \$35,000 unused limit carryover available from 1981. For 1985, employee X may be granted incentive stock options by employer M or its parent or subsidiary corporations for stock with an aggregate fair market value of \$170,000 (the base \$100,000 limitation for 1985 plus \$70,000 unused limit carryovers from 1982 and 1983 (\$35,000 in carryovers from each of such years)). While \$10,000 of unused limit carryover applicable to 1981 was never exhausted, such carryover could only be carried forward for the three immediately succeeding calendar years and hence expired at the end of 1984. Also, no carryover arises from 1984, since the entire base \$100,000 limitation was exhausted in that year.

There are some remaining questions as to this restriction under the applicable statutory provisions. For example, the wording in the statute could be interpreted to apply the \$100,000 and unused limit carryover restriction not only to options granted as incentive stock options but also to other stock options issued under plans approved by shareholders or at least to nonqualified options which are issued under plans which can also issue incentive stock options.⁴⁰⁹ Legislative history⁴¹⁰ indicates, however, that this reading is not the one intended. Rather such restriction is to apply only to incentive stock options. Temporary IRS regulations⁴¹¹ ex-

409. I.R.C. § 422A(b)(8) (West Supp. 1982), applies the "\$100,000 and unused limit carryover restriction" to all options granted in a calendar year under "all such plans" of the applicable optionee's employer corporation (and parent and subsidiary corporations thereto). The reference to "all such plans" could be read to mean all plans described in *id.* § 422A(b)(1) (i.e., plans which specify the aggregate number of shares eligible to be issued under the plan and the employees (or class of employees) eligible to be issued options, and which have obtained shareholder approval). Literally read, options under such plans need not be incentive stock options.

410. H. CONF. REP. NO. 201, 97th Cong. 1st Sess. 235 (1981).

411. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 16) (1981). The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would also confirm the "\$100,000 and unused limit carryover restriction" as applying only to incentive stock options.

pressly confirm this reading of the statute.

A second item of confusion concerns whether any unused limit carryover can arise in a calendar year after 1980 where no incentive stock option plan exists, or where the subject employee is not eligible for the award of an incentive stock option, or where the subject employee, even if eligible for an award, is not awarded any incentive stock option. For instance, if an employer creates a new incentive stock option plan, or amends an existing option plan to be able to issue incentive stock options in 1982, or, on the other hand, if an employee becomes a new employee or a new member of the class eligible for incentive stock options in 1982, or, in yet a third situation, if an employee was not awarded any incentive stock options in 1981, there is a question, in each case, whether such employee (now eligible for incentive stock options in 1982) may be issued options in 1982 for stock with an aggregate fair market value of \$150,000 (the base \$100,000 limitation for 1982 plus \$50,000 unused limit carryover from 1981). The IRS will probably eventually rule that no unused limit carryover can arise, if no incentive stock option plan ever existed previously, or the employee was not even eligible for an award of an incentive stock option before; it is hoped, however, that the IRS will allow a full \$50,000 carryover (one-half of \$100,000) if an employee eligible for an award of an incentive stock option in a year under a then-existing incentive stock option plan does not have any such options granted to him or her in such year. The Staff of the Joint Committee on Taxation has indicated, however, that a carryover can apply even where no plan existed in the prior year, provided only that the optionee had been employed for some part of the earlier year.⁴¹²

The \$100,000 plus unused limit carryover restriction is not contained in provisions applicable to restricted or qualified stock options. Because of this restriction, employers may desire to continue granting, at least to some extent, nonqualified options. Temporary IRS regulations⁴¹³ allow incentive stock options and nonqualified options to be granted under the same plan. Such grants are only permitted, however, if the grant of one type of option does not operate to reduce the number of shares available under the other type of option—a “tandem” option. This requirement is consistent with the approach taken in the qualified stock

412. See STAFF EXPLANATION, *supra* note 36, at 161.

413. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 20) (1981).

option area.⁴¹⁴

D. *Miscellaneous Rules*

1. *Payment Made with Other Employer Stock*

A new rule is added by ERTA which allows an optionee to pay for stock subject to an incentive stock option with stock of the employer already held by the optionee.⁴¹⁵ This rule appears to follow existing IRS Revenue Ruling 80-244.⁴¹⁶ This Revenue Ruling further provides that stock previously acquired from the exercise of a qualified stock option can be used to pay the price for stock granted under a nonqualified option even if the exchange occurs within the "holding period" applicable to the qualified stock option. This transaction would not result in a loss of the special tax results appropriate to qualified stock options resulting from the exchange. In substance, the acquisition of stock under the nonqualified option with stock from the qualified stock option will create no recognition of income to the extent that the nonqualified option stock has a value equal to the option price. Only stock received under the nonqualified option with a value in excess of the option price is reportable as compensation income. If this Ruling is applied to incentive stock options, it would be possible to use stock acquired from the exercise of a prior incentive stock option to pay the option price for any later incentive stock option, regardless of any compliance with the applicable holding period restrictions, and without any tax consequence at the time of the exercise. The limited taxability resulting from the exercise of a nonqualified option in which the value of shares in excess of the option price is generally subject to tax at exercise would not apply to the exercise of an incentive stock option.

Literally read, this rule could allow an employee to pyramid stock obtained from exercise of part of one incentive stock option into larger and larger amounts of stock still available under the incentive stock option. An example of pyramiding is provided in SEC Release 34-18114:⁴¹⁷

For example, suppose an insider holds an option for 5,000 shares at an exercise price of \$30. He decides to exercise the option when the stock is at \$60 by delivering one share of stock. As a result, he receives 2 shares which are automatically used to

414. See Rev. Rul. 73-359, 1973-2 C.B. 148.

415. I.R.C. § 422A(c)(5)(A) (West Supp. 1982).

416. Rev. Rul. 80-244, 1980-2 C.B. 235.

417. 46 Fed. Reg. 48147 (1981) (codified at 17 C.F.R. § 241.18114 (1981)).

purchase 4 shares under the option, which in turn are used to purchase 8 shares, and so on until the maximum number of shares purchasable under the option pursuant to this technique are received.⁴¹⁸

Thus the pyramiding does not qualify under an otherwise applicable exemption from insider trading restrictions of section 16(b) of the Securities Exchange Act of 1934.⁴¹⁹ It might be expected that future IRS regulations will restrict the use of this method of pyramiding shares.

At this time, the IRS refuses to issue any advance rulings as to whether the nontax rule of Revenue Ruling 80-244 will apply to the payment of stock pursuant to exercise of an incentive stock option with other stock of the employer already held by the optionee.⁴²⁰ This may indicate that the IRS is attempting to formulate final rules that will not permit pyramiding.⁴²¹

2. *Transfers by an Insolvent Individual*

The statute provides that the applicable holding period restrictions will not apply in circumstances in which stock is acquired pursuant to the exercise of an incentive stock option by an insolvent individual who then transfers such stock to a trustee, receiver, or similar fiduciary in a bankruptcy or similar insolvency proceeding.⁴²² This rule is the same as that applied to qualified stock options.⁴²³

3. *Preference Income*

Until taxable years beginning after 1982, section 56 of the Code provides for individuals an additional tax on "tax preference items" described in Code section 57. As originally enacted by ERTA, and effective until taxable years beginning after 1982, the amount by which the fair market value of a share transferred pursuant to an incentive stock option exceeds the option's price is

418. 46 Fed. Reg. at 48167, n.132.

419. 15 U.S.C. § 78(b) (1976).

420. Rev. Proc. 82-18, 1982-11 I.R.B. 23.

421. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would hold that, if stock obtained from the prior exercise of any statutory option (including an incentive stock option) prior to the expiration of its applicable "holding period" requirement is used to exercise a new incentive stock option after March 15, 1982, then the special tax rules for the prior statutory option will not apply and the optionee will have tax on the entire past appreciation in the value of the shares used to exercise the new option. See *supra* notes 365-67 and accompanying text.

422. I.R.C. § 422A(c)(3) (West Supp. 1982).

423. I.R.C. § 422(c)(5) (Supp. IV 1980).

not a tax preference item under Code section 57. This is different from the law applicable to restricted and qualified stock options.⁴²⁴ For certain employees, an old qualified stock option may have been granted on or after January 1, 1976 and exercised on or after January 1, 1981, but prior to May 21, 1981 to be eligible for the favorable tax treatment described above.⁴²⁵ As will be discussed in detail below, where no prior-granted option is to be treated as an incentive stock option, it may be possible for the granting corporation to elect to treat at least a portion of such option as an incentive stock option. While most tax results would be the same as before, this election might avoid the creation of section 57 preference income upon exercise of the option. In addition, the holding period restriction required to obtain favorable tax treatment would be easier to meet than before election. It is possible, however, that the IRS will rule that qualified stock options, exercised as such, may not be converted to incentive stock options.

For taxable years beginning after 1982, the 1982 Tax Equity Act has changed the preference income rule, so as to make the excess of the fair market value of a share transferred pursuant to an incentive stock option over the option price a tax preference item.⁴²⁶ While, for individuals, the additional tax under Code section 56 is eliminated, items of tax preference will after 1982 be used to determine the minimum tax required to be paid under section 55 of the Code.⁴²⁷

4. *Receipt of Property with Option*

The statute provides that an employee has a right to receive property at the time of exercise of an incentive stock option.⁴²⁸ Property, as used here, appears to refer to stock appreciation rights, bonuses, and other similar items. Temporary IRS regulations⁴²⁹ expressly allow the grant of a "tandem" incentive stock option-stock appreciation right only if certain conditions are met.⁴³⁰

424. I.R.C. § 57(a)(6) (1976).

425. *See id.* § 422(b), (c)(7).

426. Tax Equity Act § 55.

427. *Id.*

428. I.R.C. § 422A(c)(5)(B) (West Supp. 1982).

429. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 39) (1981).

430. *See supra* notes 401-402 and accompanying text.

5. *Additional Provisions*

The statute provides that additional provisions may be contained in an incentive stock option, so long as such additional provisions are not inconsistent with the incentive stock option rules.⁴³¹ One additional provision that appears possible in an incentive stock option is one that allows only a portion of the shares subject to the option to vest and hence be exercisable in any year. However, the sequential rule⁴³² will mean that delayed vesting of one incentive stock option will prevent any part of a later-granted incentive stock option from being exercised. In other words, an installment incentive stock option is the grant of a single option; the sequential rule will restrict the exercise of any later-granted incentive stock option until either the exercise or expiration of all installments of the earlier-granted incentive stock option.⁴³³ As a result, staggered vesting of incentive stock options may become a relic of the past.

6. *Reporting Requirements*

Any corporation which transfers in a calendar year stock pursuant to the exercise of an incentive stock option must furnish to the transferee on or before the January 31 following the end of such year a written statement as to the nature of the transfer, as prescribed by the Secretary of the Treasury in regulations.⁴³⁴ This is the same requirement as applied to transfers of shares pursuant to the exercise of qualified and restricted stock options.

E. *Special Loan Problems*

Some plans contain loan provisions which enable employees to purchase stock subject to options. While not directly affected by ERTA provisions, the Act raises several important points as to this issue. The Tax Court has consistently held that interest-free loans do not constitute income to the borrowing employees.⁴³⁵ If the lender charges less than 9% per annum simple interest, how-

431. I.R.C. § 422A(c)(5)(C) (West Supp. 1982).

432. The "sequential" rule provides that an incentive stock option may not be exercised until a previously granted incentive stock option is exercised in full or expires by lapse of time. See *supra* notes 399-404 and accompanying text.

433. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 37) (1981).

434. I.R.C. § 6039(a) (West Supp. 1982).

435. See *e.g.*, *Beaton v. Commissioner*, 40 T.C.M. (CCH) 1324 (1980); *Greenspun v. Commissioner*, 72 T.C. 931 (1979); *Dean v. Commissioner*, 35 T.C. 1083 (1961). *But see Hardee v. United States*, Daily Tax Rep. (BNA) No. 135 at H-1 (July 14, 1982) (Ct. Cl. Tr. Div.) (holding that interest free loans may be income to the borrowing employee).

ever, section 483 of the Code will cause part of the option price to be deemed "unstated interest." This may reduce the true option price, i.e., the price of the shares disregarding the interest charge for the loan. If this reduction makes the true option price less than 100% of the fair market value of the shares subject to the option at the time of the grant, the option will not qualify as an incentive stock option.⁴³⁶ In this regard, old IRS regulations under Code section 422 state that a failure to have the option price meet the "100% test" by reason of the operation of Code section 483 will not be considered a good faith attempt at meeting the test.⁴³⁷

Furthermore, if an interest rate is to be set on such a loan, and the plan generally provides loans, the interest rate should not be usurious. Usury is defined by either the state usury rate or, if greater, a "federal preemption rate." The Depository Institutions Deregulation and Monetary Control Act of 1980,⁴³⁸ as amended,⁴³⁹ provides that, unless a state specifically overrides its provisions, the usury limit for business loans of \$1,000 or more is the discount rate in the local federal reserve district on ninety-day commercial paper, together with any surcharge thereon, plus 5%.⁴⁴⁰ While not conclusively decided by ruling or court decision, it is arguable that a loan obtained to purchase stock will be considered a business loan.⁴⁴¹ This federal law becomes ineffective for loans made after April 1, 1983, unless otherwise extended by Congress.⁴⁴²

F. *Effective Dates and Applicability to Existing Options*

ERTA section 251(c)(1)(A) provides that provisions concerning incentive stock options are effective for options granted on or after January 1, 1976 and exercised on or after January 1, 1981. Temporary IRS regulations⁴⁴³ note that the controlling date for

436. See I.R.C. § 422A(b)(4) (West Supp. 1982).

437. Treas. Reg. § 1.422-2(e)(2)(ii), T.D. 6887, 1966-2 C.B. 129. See *supra* notes 392-93 and accompanying text.

438. Pub. L. No. 96-221, 94 Stat. 132, 161-68 [hereinafter Deregulation Act] (codified in scattered sections of 12 U.S.C.).

439. Housing and Community Development Act of 1980, Pub. L. No. 96-399, § 324(b), (d), 94 Stat. 1614, 1647-48 (1980) (codified as amended at 12 U.S.C. § 86(a) (Supp. IV 1980)).

440. 12 U.S.C. § 86(a) (Supp. IV 1980).

441. See *Adema v. Great Northern Development Co.*, 374 F. Supp. 318 (D. Ga. 1973) (purchase of real estate lots for investment represents a business purpose).

442. Deregulation Act § 512, 94 Stat. at 164.

443. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 8) (1981).

any option is the date of the original grant, and a modification, extension, or renewal on or after January 1, 1976 of any option granted before that date will not make that option eligible for incentive stock option treatment. The option remains ineligible regardless of whether the option, as so modified, extended, or renewed, would be treated as newly granted under the provisions of section 425(h) of the Code.

ERTA section 251(c)(1)(B) further provides, however, that, as to options granted on or after January 1, 1976 but prior to January 1, 1981, the granting corporation must elect (in a manner to be determined by the Secretary of the Treasury or his or her delegate) to have the incentive stock option provisions apply.⁴⁴⁴ Temporary IRS regulations⁴⁴⁵ state that a corporation may make only one election. Therefore, an election that the incentive stock option provisions apply to certain pre-1981 granted options will foreclose the corporation from making any later elections as to any other pre-1981 options. These temporary regulations further note that an election must be made at least by the filing date (including extensions) for the federal income tax return for the corporation for the earlier of (1) its first taxable year during which an incentive stock option (either pre-1981 or otherwise) is exercised or (2) its taxable year which includes December 31, 1982.⁴⁴⁶ If this rule (by virtue of alternative (1)) would require such a filing before August 14, 1982, however, the employer will be entitled to make the election at any time prior to August 14, 1982 on a statement attached to an amended return.⁴⁴⁷

The temporary regulations⁴⁴⁸ provide that the election shall be made by attaching to the applicable income tax return (or amended return) a statement that contains the name, address, and taxpayer identification number of the corporation, identifies the election as one under ERTA section 251(c)(1)(B), and specifies, by employee, the options to which the election applies. For each option so elected, the filing must state the option's date of original grant (and, if applicable, the date of the most recent modification

444. ERTA § 251(c)(1)(B).

445. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 4) (1981).

446. *Id.*

447. *Id.*

448. *Id.* These temporary regulations change slightly prior temporary regulation § 5C.0 as to the making of the election. An employer which previously filed under the temporary regulations prior to December 21, 1981 need not amend such election to conform to the new temporary regulations, but it can amend the prior election under the new rules, if desired.

thereof), and the total option price, i.e., the total number of shares to the option multiplied by the option price per share. Also, the fair market value (determined when an option is granted) of shares acquired pursuant to exercise of options eligible for incentive stock option treatment is limited for any one employee to \$50,000 per calendar year and to \$200,000 in the aggregate for the years 1976 through 1980.⁴⁴⁹ The \$50,000 per year limit relates only to the year of grant of an option and not to the year of vesting or exercise.⁴⁵⁰ Also, no carryover provisions will apply to the \$50,000 per year limit.⁴⁵¹

As indicated above,⁴⁵² a corporation may choose eligible prior options for incentive stock option treatment on an option by option or employee by employee basis. Often, only part of an option may be specified for incentive stock option treatment. This will often occur by reason of the requirement that the aggregate value, at the time of the grant of stock for which an employee may be granted incentive stock options for years prior to 1981, may not exceed \$50,000 per calendar year and \$200,000 in the aggregate for the years 1976 through 1980.⁴⁵³ If only part of any option is elected for incentive stock option treatment, the temporary IRS regulations indicate that, if such option is not exercised prior to January 21, 1982, the option must be amended to indicate a split in the option between shares subject to incentive stock option treatment and those not eligible for such treatment.⁴⁵⁴ Furthermore, when that option is exercised, separate stock certificates must be issued applicable to each of the incentive stock option and non-incentive stock option treatments so elected.⁴⁵⁵ If such option was exercised prior to January 21, 1982, the option had to be split by issuing or reissuing separate stock certificates for the portion of the option eligible for incentive stock option treatment and that portion not so eligible.⁴⁵⁶ In this case, the issuance or reissuance of such stock certificates had to occur by March 15, 1982.⁴⁵⁷

An option granted prior to 1981 which is eligible for incentive

449. ERTA § 251(c)(1)(B).

450. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 19) (1981).

451. *Id.*

452. See *supra* note 448 and accompanying text.

453. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 6, 7) (1981).

454. *Id.* § 14a.422A-1 (Q. and A. 18).

455. *Id.*

456. *Id.* § 14a.422A-1 (Q. and A. 7).

457. *Id.*, as modified by IRS Announcement IR-82-7, Daily Tax Rep. (BNA), No. 10, Jan. 15, 1982, at G-4.

stock option treatment—if a corporation elects that the option receive such treatment—must qualify under all the incentive stock option requirements. Such qualification must occur under either the original or modified terms of the option, or must occur by reason of a new amendment made either prior to the making of the election or, if the exercise of the option takes place earlier, upon such exercise.⁴⁵⁸ ERTA section 251(c)(2) allows options granted on or after January 1, 1976 and outstanding (i.e., unexercised) on August 13, 1981 (the date of enactment of ERTA) to be amended to comply with the requirements applicable to incentive stock options, without such amendment being considered a modification under Code section 425(h) and, therefore, the grant of a new option. If the amendment of an existing option were considered a modification, and hence a grant of a new option, and if the fair market value of the stock subject to the option were to increase since the grant of the original option, it is likely that the option price would be less than 100% of the fair market value of the subject stock at the time of the modification. Hence, the option would not qualify as an incentive stock option. An amendment of an outstanding option under this provision must be made within one year of the date of enactment of ERTA, or, in other words, prior to August 14, 1982.⁴⁵⁹

Many options granted prior to the enactment of ERTA will not comply with all of the requirements needed to qualify as an incentive stock option. However, prior options meeting the old qualified stock option rules should meet most of the incentive stock option rules.

Two of the new rules probably will not be met by the older options. The first rule concerns the sequential rule discussed earlier.⁴⁶⁰ Temporary IRS regulations indicate that lack of such a sequential rule in an option exercised prior to January 21, 1982 will not disqualify the option from incentive stock option treatment. There must, however, be no prior outstanding incentive stock option at the time of the exercise of the subject option.⁴⁶¹ In addition, the lack of a sequential rule will not invalidate an option from incentive stock option treatment if the option is exercised on or after January 21, 1982 so long as there is not a prior outstanding incentive stock option at the time of the grant of the subject

458. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 4, 12) (1981).

459. ERTA § 251(c)(2).

460. See *supra* notes 399-404 and accompanying text.

461. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 13) (1981).

option.⁴⁶² A prior outstanding incentive stock option will include any previously granted option which is amended at a later time so as to qualify for incentive stock option treatment.⁴⁶³ These conditions generally follow old regulations under Code section 422, which held that a qualified stock option need not contain the sequential rule previously applicable to such options if no prior qualified or restricted stock options existed as to the applicable employee.⁴⁶⁴

The second rule which probably will not be met by options granted prior to ERTA concerns the \$100,000 and unused limit carryover restriction⁴⁶⁵ which, normally, must be expressly stated in the plan.⁴⁶⁶ Temporary IRS regulations indicate, however, that failure to state this restriction in the specific provisions of the plan will not disqualify an option from incentive stock option treatment if the option is exercised before January 21, 1982 and the restriction is not exceeded.⁴⁶⁷ To meet the restriction, it might be necessary to split the option by issuing or reissuing separate stock certificates for the portion of the option eligible for incentive stock option treatment and for the portion of the option not so eligible.⁴⁶⁸ The issuance or reissuance of such stock certificates had to occur no later than March 15, 1982.⁴⁶⁹ If a previously granted option is not exercised before January 21, 1982, and if the \$100,000 and unused limit carryover restriction limit is exceeded by the option, the option would need to be amended prior to its exercise to indicate a split into incentive and non-incentive stock

462. *Id.*

463. *Id.* § 14a.422A-1 (Q. and A. 13, 38) (1981). As a result, some elections of incentive stock option treatment for previously granted options could disqualify later granted (and earlier-exercised) options from incentive stock option treatment. For example, assume that in early 1982, a corporation grants to an employee an incentive stock option which is exercised soon thereafter. Later still, the corporation properly elects to treat a prior option granted in 1978 for incentive stock option treatment, which prior option has not yet been exercised. Such election has the effect of disqualifying the 1982 option from incentive stock option treatment, because the 1978 option was still outstanding at the time of grant of the 1982 option.

464. Treas. Reg. § 1.422-2(f)(1)(iii), T.D. 6887, 1966-2 C.B. 129.

465. See *supra* notes 405-08 and accompanying text.

466. I.R.C. § 422A(b)(8) (West Supp. 1982).

467. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 14) (1981).

468. *Id.*

469. *Id.*, as modified by IRS Announcement IR-82-7, Daily Tax Rep. (BNA), No. 10, Jan. 15, 1982, at G-4. Similar rules exist for the issuance or reissuance of stock certificates to meet the "\$50,000/\$200,000 restriction" applicable to options granted before 1981 that are intended to qualify for incentive stock option treatment, where such options are also exercised before January 21, 1982.

option portions.⁴⁷⁰ In the case of an option subject to the \$100,000 and unused limit carryover restriction, the plan must add that restriction before exercise.⁴⁷¹

The provisions allowing amendment of previously granted options apply only to options outstanding (i.e., unexercised) on August 13, 1981.⁴⁷² Thus, options not qualifying as incentive stock options without amendment, which were exercised before that date, may not now be amended. Also, temporary IRS regulations require that any amendment needed to qualify an option as an incentive stock option be made prior to the exercise of the option, except, as noted above, with respect to the sequential and \$100,000 and unused limit carryover restriction rules.⁴⁷³ Also, if shareholder approval of the plan under which an option is granted is needed to qualify such option as an incentive stock option, such shareholder approval (if prior to August 14, 1982) can be obtained after exercise of the option and still qualify the option as an incentive stock option.⁴⁷⁴

IRS temporary regulations expressly provide that the only amendments which will be allowed in converting existing options to incentive stock options, without the amendments being considered modifications and hence new grants of the options, will be those absolutely necessary to qualify the options for such treatment.⁴⁷⁵ If other types of amendments are adopted, such as those adding alternative stock appreciation rights, those adding rights to exercise options with previously-acquired corporate stock, those adding rights to receive cash bonuses upon exercise of the options, those extending the exercise period for the options, those extending the period of time to pay for the options, or adding loan provisions under the options, the amendments will be held to be modifications of the prior options and hence "new" grants.⁴⁷⁶ Thus, the option price would need to be 100% of the fair market value of the stock subject to the option at the time of this new grant in order for the option to qualify as an incentive stock option.⁴⁷⁷ In cases where the fair market value of the stock subject to the option has been appreciating, therefore, no amendments

470. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 18) (1981).

471. *Id.*

472. ERTA § 251(c)(2).

473. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 12) (1981).

474. STAFF EXPLANATION, *supra* note 36, at 162-63.

475. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 25) (1981).

476. *Id.*

477. I.R.C. § 422A(b)(4) (West Supp. 1982).

other than the ones absolutely necessary to convert that option to an incentive stock option should be agreed to unless the parties also elect to increase the option price to 100% of the fair market value of the stock at the time of such amendments.

In addition, if a previously granted option was amended before August 13, 1981, the date of enactment of ERTA, to add an additional benefit or right, such amendment will be deemed a modification and hence a new grant of the option.⁴⁷⁸ Thus, if the option price, while originally set at 100% of fair market value of the shares subject to the option, was less than 100% of such shares' fair market value at the time of modification, the option may not qualify for incentive stock option treatment unless one of two approaches is taken. One approach is to amend the option so as to raise the option price to 100% of the subject shares' fair market value determined at the time of modification prior to the earliest of: (1) the exercise of the option; (2) the election by the granting corporation of incentive stock option treatment for the option; or (3) August 14, 1982.⁴⁷⁹ As an alternative, the IRS temporary regulations permit the "rescission" of the prior amendment to the option. For example, where the prior amendment added the right to pay the option price in stock, that right may be rescinded and, therefore, the previously set option price will qualify the option for possible incentive stock option treatment.⁴⁸⁰ This rescission of a prior amendment must likewise be made prior to the earliest of the three time periods listed above⁴⁸¹ in order to allow the prior option price to be consistent with incentive stock option treatment. In other words, the rescission must be made within the time allowed for any conforming incentive stock option amendment.⁴⁸² Also, the rescission need only apply to the part of the option which is intended to qualify as an incentive stock option.⁴⁸³

As to options still outstanding on August 13, 1981, ERTA section 251(c)(2) appears to imply that the granting corporation can unilaterally change the terms of existing options to meet the incentive stock option rules. However, such a unilateral action would violate state contract law. A prior granted option represents a contract between the granting corporation and the optionee, and

478. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 9) (1981).

479. *Id.* § 14a.422A-1 (Q. and A. 11).

480. *Id.* § 14a.422A-1 (Q. and A. 9).

481. See *supra* note 479 and accompanying text.

482. *Id.*

483. Rev. Rul. 82-32, 1982-9 I.R.B. 5.

should not ordinarily be modifiable without both parties' consent. This suggests that the choice between exercising the option under its existing terms or exercising the option with certain amendments thereto as an incentive stock option, be left to the optionee.

One problem with this approach, however, arises out of Revenue Ruling 73-26.⁴⁸⁴ Under that ruling, if an employee receives two options, one a qualified stock option and another a nonqualified option, and if the exercise of one would reduce the shares available for the other, the IRS would view the options in tandem and hold that a single, nonqualified option had actually been granted to the employee. This single, nonqualified option would not be eligible for the special tax results appropriate for qualified stock options. The new temporary regulations issued by the IRS apply this ruling to incentive stock options.⁴⁸⁵ While it could be argued that the "tandem" ruling could apply where an employee can choose to treat an option as nonqualified or as an incentive stock option under amended terms, it appears clear under both the statute and the new temporary regulations that any amendment to an option signed by both the optionee and the granting corporation prior to August 14, 1982, should be effective for any exercise of the option made after the amendment.

Finally, while an option granted after August 13, 1981, could be amended to qualify for incentive stock option treatment, any such amendment would be considered a modification and hence a new grant of the option.⁴⁸⁶ Thus, unless the option price still qualifies, or is amended to qualify, as 100% of the fair market value of the shares subject to the option at the time of the modification, the amended option will not qualify for incentive stock option treatment.⁴⁸⁷

III. OTHER EMPLOYEE BENEFIT PLAN CHANGES

A. *Employee Award Programs*

The subject of employee award programs is associated with two legal problems: whether the employees receiving the awards must include the value of such awards in gross income for tax purposes; and whether the employers making the awards can de-

484. 1973-1 C.B. 204 (Revenue Ruling 73-26 was directed at old qualified stock options).

485. Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 39) (1981).

486. I.R.C. § 425(h) (West Supp. 1982); Temp. Treas. Reg. § 14a.422A-1 (Q. and A. 26) (1981).

487. I.R.C. § 422A(b)(4) (West Supp. 1982).

duct the value of such awards from their gross income. These issues, although related, are not dealt with in the same manner. Whether employee awards and other fringe benefits are taxed to employees depends on the facts and circumstances of each situation. Some awards, because of nominal value, administrative convenience or other reasons, may not be includible as income to recipient-employees. If employee awards are included as taxable income to employees, the employers should be able to deduct such awards as compensation paid.⁴⁸⁸ Thus, because of the special provision noted below which provides for the deduction of employee awards, it may logically be interpreted that such awards do not represent taxable income to employees receiving them.⁴⁸⁹ If such items do represent taxable income to the subject employees, there should be no need for a special Code provision providing for deduction to employers granting the awards.

Awards not includible in employees' compensation are definitely subject to section 274 of the Code. Prior to ERTA, section 274 stated that business "gifts" were deductible only up to twenty-five dollars per recipient for one taxable year. The term "gift" was defined as any item excludible from gross income of the recipient under Code section 102.⁴⁹⁰ In addition, Code section 274 stated that a gift did not include:

- (1) An item having a cost to the business not in excess of four dollars on which the name of the business is clearly and permanently imprinted and which is one of a number of identical items distributed generally by the business;
- (2) A sign, display rack or other promotional material to be used on the business premises of the recipient; and
- (3) An item of tangible personal property having a cost to the business not in excess of \$100 and which is awarded to an employee by reason of length of service or for safety achievement.

ERTA section 265(a) amends item 3 to exclude further from the term "gift" an item of tangible personal property which is awarded to an employee by reason of length of service, productivity or safety achievement, but only to the extent that either (1) the cost of such item to the business does not exceed \$400 or (2) the item constitutes a qualified plan award.⁴⁹¹ ERTA section 265(b),

488. See I.R.C. § 162(a)(1) (1976).

489. The IRS rejects this position, however. See IRS News Release, IR-81-138, 4 PENS. & PROFIT SHARING (P-H) ¶ 107,407 (Dec. 21, 1981).

490. I.R.C. § 274(b)(1) (1976).

491. I.R.C. § 274(b)(1)(C) (West Supp. 1982).

in further amending Code section 274, defines a "qualified plan award" as an item which is awarded under a plan: (1) which is a permanent written plan; (2) which does not discriminate in favor of officers, shareholders, or highly compensated employees as to eligibility or benefits; and (3) under which the average cost of all items awarded during a taxable year does not exceed \$400. Furthermore, no item, even if otherwise qualifying, will be considered a qualified plan award to the extent its cost exceeds \$1,600.⁴⁹² These amendments are effective for taxable years ending on or after August 13, 1981—the date of enactment of ERTA.⁴⁹³

As a result of ERTA, a deductible award to an employee may be given if such award has a cost of no more than \$400, or, if more than \$400, such award may be given to the extent that it does not exceed a cost of \$1,600 and is a qualified plan award. Under prior law, any award over \$100 in cost was not eligible for deduction under Code section 274.⁴⁹⁴ Under ERTA, even if an award exceeds \$400 and is not a qualified plan award, up to \$400 of the cost of the award is eligible for deduction.⁴⁹⁵

As noted above, a "qualified plan award" must not discriminate in favor of officers, shareholders, or highly compensated employees.⁴⁹⁶ Employee awards, however, are based on length of service, productivity, or safety achievement. These criteria are somewhat ambiguous factors tending to favor older, more important employees. Therefore, it will be difficult to determine if a program on its face is discriminatory. It can be anticipated that the IRS, in final regulations, will attempt to specify a direct limitation, such as some percent of the total awards under the plan, that can be spent on awards to the prohibited group each plan year. Until regulations are issued, there will remain a real question as to how a program can be structured so that it does not discriminate against the rank and file.

Certain matters concerning employee awards follow pre-ERTA law. For instance, any employee award, regardless of whether it meets the \$400 test or the qualified plan award test, must be an item of tangible personal property.⁴⁹⁷ Revenue Ruling

492. *Id.* § 274(b)(3)(C).

493. ERTA § 265(c).

494. I.R.C. § 274(b)(1)(C) (1976).

495. I.R.C. § 274(b)(1)(C)(i) (West Supp. 1982).

496. *Id.* § 274(b)(3)(A).

497. *Id.* § 274(b)(1)(C).

59-58,⁴⁹⁸ and case law⁴⁹⁹ indicate that a retail gift certificate is not considered tangible personal property. Also, any employee award, regardless of whether it meets the \$400 test or the qualified plan award tests, must be given by reason of length of service, productivity, or safety achievement.⁵⁰⁰ The awards contemplated here are those for special achievement, not those likened to bonus or pay supplements such as awards in recognition of number of hours worked.

B. *Fringe Benefit Regulations Deferred*

Under present law, Code section 61 defines gross income to include all income from whatever source derived, regardless of whether paid in cash, property, or services.⁵⁰¹ This test has not always been followed, however, particularly in the employment area. Some fringe benefits, such as employee health insurance, are specifically excluded from income by statute.⁵⁰² Other items are excluded under administrative practice as *de minimus* (i.e., the record keeping that would be required if the benefit were included in gross income would be administratively burdensome or impractical), or by judicial or administrative practice because of either problems in valuation or widely held views that the items do not constitute income.⁵⁰³

In 1978, Congress enacted a law⁵⁰⁴ to prohibit the IRS from issuing regulations relating to fringe benefits prior to 1980 and to make any eventual regulations ineffective before that year. This freeze was later extended until May 31, 1981.⁵⁰⁵ The IRS, in the meantime, issued a draft of fringe benefit regulations for purposes of discussion.⁵⁰⁶ ERTA section 801 extends the freeze on regulations to December 31, 1983, to enable Congress and the IRS to study the issues. Thus, the IRS may not currently issue fringe benefit regulations. Any such regulations, when eventually issued, may not be retroactive prior to December 31, 1983.

498. Rev. Rul. 59-58, 1959-1 C.B. 17.

499. See, e.g., *Hallmark v. U.S.*, 200 F. Supp. 847 (W.D. Mo. 1961).

500. I.R.C. § 274(b)(1)(C) (West Supp. 1982).

501. I.R.C. § 61 (1976); Treas. Reg. § 1.61-1, T.D. 627, 1957-2 C.B. 18.

502. I.R.C. §§ 105, 106 (West Supp. 1982).

503. See H.R. REP. No. 201, 97th Cong., 1st Sess. 282 (1981).

504. Act of Oct. 7, 1978, Pub. L. No. 95-427, 92 Stat. 996.

505. Act of Dec. 29, 1979, Pub. L. No. 96-167, 93 Stat. 1275.

506. [1982] 4 PENS. & PROFIT SHARING (P-H) ¶ 125,220.

C. Property Subject to Substantial Risk of Forfeiture

Section 83 of the Code provides that most property, including stock not eligible for incentive stock option treatment under section 422A of the Code, transferred to an employee in connection with services rendered will be taxable as compensation income only when such property is first transferable and will not be subject to a substantial risk of forfeiture. If the property is nontransferable and is subject to a substantial risk of forfeiture, however, the employee could make a section 83(b) election. This permits the employee to have the property taxed at the time of transfer based on its fair market value at that time (disregarding all restrictions except for permanent restrictions on the property) less any payment of the employee for such property.⁵⁰⁷ By such election, any later appreciation in the property may be capital gain rather than ordinary income.

Section 16(b) of the Securities Exchange Act of 1934⁵⁰⁸ prohibits certain corporate insiders (officers, directors, and 10% shareholders) from keeping the profit derived from any purchase and sale of stock, within a six month period, of the insider's corporation. This rule is designed to prevent such insiders from using information not available to the general public to obtain profits from "short-swing" securities trading. The Tax Court previously held that stock transferred to a corporate insider was not nontransferable at the time of transfer, even if it was subject to the restrictions of section 16(b). Therefore, the property was taxable at the time of transfer.⁵⁰⁹

ERTA section 252(a) amends Code section 83 to change this result. Stock transferred while still subject to the restrictions of section 16(b) will be deemed nontransferable and subject to a substantial risk of forfeiture so long as the sale of the stock at a profit could subject the recipient to suit under section 16(b). As a result, an employee receiving stock subject to section 16(b) restrictions will not, unless he or she makes a section 83(b) election to have the stock taxed at transfer, be taxed on the transfer of the stock until the section 16(b) restrictions have elapsed. However, unless a section 83(b) election is made, the deferral of tax could cause the appreciation in the stock which has occurred before the section

507. I.R.C. § 83(b) (1976).

508. 15 U.S.C. § 78p(b) (1976).

509. *Horwith v. Commissioner*, 71 T.C. 932 (1979).

16(b) restrictions have elapsed to be taxed as compensation income rather than as capital gain.

Also, the statute is written somewhat loosely, in that it states that the transferred stock will be considered as nontransferable and subject to a substantial risk of forfeiture so long as a sale of the stock at a profit causes section 16(b) to be involved.⁵¹⁰ Section 16(b) is applicable to purchases and sales made within less than six months. Thus, if the transferred stock is sold at a profit by an insider eight months after the initial transfer, but the insider had purchased or does purchase other stock of the same class within the six months before or the six months after the sale of the initially transferred stock, it is possible that section 16(b) will apply to that sale. IRS regulations probably will eliminate this possibility of an unlimited deferral, perhaps by automatically ruling that the transferred stock is no longer subject to a substantial risk of forfeiture and is not nontransferable after six months have elapsed following the initial transfer of the stock. This latter position is adopted by the Staff of the Joint Committee on Taxation.⁵¹¹

ERTA section 252(b) amends Code section 83 to apply the same rule to stock transferred to a corporate officer during the period when it must be retained by such officer for compliance with the "Pooling-of-Interests Accounting" sometimes required by the Securities and Exchange Commission.⁵¹² These amendments made by ERTA section 252 are effective for taxable years ending after December 31, 1981.⁵¹³

D. *Dependent Care Assistance Programs*

ERTA section 124 adds a new section 129 to the Code (old section 129 becomes section 130) providing a tax incentive for creation of employer-sponsored dependent care assistance programs.⁵¹⁴ The new section excludes from employee gross income certain amounts paid or incurred by the employer for dependent care assistance provided to the employee, if furnished under a program which meets Code requirements.⁵¹⁵ For purposes of this

510. I.R.C. § 83(c)(3) (West Supp. 1982).

511. STAFF EXPLANATION, *supra* note 36, at 164.

512. See Accounting Series Release Numbered 1303 (Oct. 5, 1972), 37 Fed. Reg. 20937, 17 C.F.R. 211.130; Accounting Series Release Numbered 135 (Jan. 18, 1973), 38 Fed. Reg. 1734, 17 C.F.R. 211.135.

513. ERTA § 252(c). The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), makes the provisions effective for all *transfers* after 1981.

514. I.R.C. § 129 (West Supp. 1982).

515. *Id.* § 129(a).

section, "employee" includes a self-employed person.⁵¹⁶

In considering such a program, the incentive for the employer is similar to that for adoption of a group term life insurance program qualified under section 79 of the Code. The employer is able to confer a benefit upon his employees which is wholly or partially tax free.⁵¹⁷ As with group term life insurance, there is no special tax credit or deduction for the employer for amounts paid or incurred under the plan. These amounts would typically be deducted under section 162 of the Code as ordinary and necessary business expenses.⁵¹⁸ Presumably, the program could reimburse employee expenditures. However, Code section 129(e)(1) may restrict the exclusion to apply only to direct payment for services or direct provision therefor.⁵¹⁹ The IRS interpretation of comparable language in proposed Treasury Regulation section 1.127-1(a), concerning educational assistance programs for employees, indicates that employee reimbursement will be permitted.

Tax reporting for the assistance plan is simplified by ERTA section 124(e)(2). This section amends Code sections 3121(a)(18), 3306(b)(13), and 3401(a)(19) (formerly section 3401(a)(18)) to exclude amounts paid or benefits furnished to or for the benefit of an employee from the definition of "wages" under the Federal Insurance Contributions Act, the Federal Unemployment Tax Act and the provisions on withholding tax at the source. Exclusions occur, however, only if it is reasonable to believe that the employee will be able to exclude the payment or benefit under Code section 129. ERTA section 124(e)(2)(B) makes a corresponding change to section 209(q) of the Social Security Act of 1935.⁵²⁰ Thus, withholding is avoided. The employee's ultimate Social Security benefit, however, may be reduced due to the exclusion.

In order for the exclusion to be available, a qualified "dependent care assistance program" must be in effect.⁵²¹ This program must be a separate, written plan of an employer for the exclusive benefit of his or her employees.⁵²² The requirement that the plan be separate may disqualify a plan not created by a separate docu-

516. *Id.* § 129(e)(3).

517. *Id.* § 129(a).

518. I.R.C. § 162(a)(1) (1976). *See also* Treas. Reg. § 1.162-10(a), T.D. 6291, 1958-1 C.B. 63.

519. I.R.C. § 129(e)(1) (West Supp. 1982).

520. Social Security Act of 1935, ch. 531, 49 Stat. 620 (codified in scattered sections of 42 U.S.C.).

521. I.R.C. § 129(a) (West Supp. 1982).

522. *Id.* § 129(d)(1).

ment, which plan is merely an article or section of a collective bargaining agreement, or part of a plan providing other benefits.⁵²³ In order to qualify, the program's employee classification must not discriminate in favor of officers, owners, or highly compensated employees, or their dependents.⁵²⁴ Unlike the nondiscrimination test for tax qualified pension, stock bonus, and profit sharing plans, there is no safe-harbor percentage test for these plans.⁵²⁵ As with such qualified plans, however, members of a collective bargaining unit may be excluded if there is evidence that dependent care benefits were the subject of good faith bargaining.⁵²⁶ Although the statute clearly states that tests of plan qualification are to be based upon benefit availability and not upon utilization, the mechanism of the availability/utilization rules apparently is concerned with selection of different program options rather than with the type of employees who may participate.⁵²⁷

Even if the plan meets the basic nondiscrimination test, it will cease to be qualified if more than 25% of the amounts paid or incurred by the employer during the year may be provided for that class of individuals who are shareholders or owners (or their spouses or dependents), each of whom on any day of the year owns more than 5% of the stock or of the interest in the capital or profits of the employer.⁵²⁸ Presumably, if more than 25% of the outlay is used for the benefit of individuals who, on any day of the year, fall within the prohibited 5% ownership group, the program will be disqualified. This is the IRS interpretation of similar language found in Code section 127(b)(3) regarding educational assistance programs.⁵²⁹

The statute fails to indicate the year with respect to which the

523. Prop. Treas. Reg. § 1.127-2(b) (1981) indicates an IRS interpretation of similar language under I.R.C. § 127 (Supp. IV 1980), describing qualified educational assistance programs, to the effect that the plan must be limited to provision of that benefit alone.

524. I.R.C. § 129(d)(2) (West Supp. 1982).

525. See I.R.C. § 410(b)(1)(A) (1976). Prop. Treas. Reg. § 1.127-2(e)(1) (1981) indicates that the IRS intends principles similar to those applied under I.R.C. § 410(b)(1)(B) to be applicable to educational assistance programs described in I.R.C. § 127. The nondiscrimination requirement for those plans is essentially identical to that for dependent care assistance programs. See also I.R.C. § 127(b)(2) (Supp. IV 1980).

526. I.R.C. § 129(d)(2) (West Supp. 1982). Cf. *id.* 410(b)(3)(A) (exclusion of employees not covered by collective bargaining agreement).

527. *Id.* § 129(e)(6). This appears to be the IRS interpretation found in Prop. Treas. Reg. § 127-2(e)(2)(i) (1981), of comparable language found in I.R.C. § 127(c)(5)(A) (Supp. IV 1980).

528. I.R.C. § 129(d)(3) (West Supp. 1982).

529. Prop. Treas. Reg. § 1.127-2(f) (1981).

test is applied. Because the section deals primarily with exclusions from income in the employee's taxable year, arguably that year would control. However, the employer makes the payments, and, therefore, arguably its taxable year should control. Proposed regulations interpret similar language in Code section 127(b)(3) to refer to the program year which must be either the calendar year or the employer's taxable year and which must be specified in the plan.⁵³⁰ Of course, determination of the IRS position on this point is crucial to fail-safe protections for such plans. If the 25% limit is a concern, consideration might be given to a charge for on-premises facilities or a reduction in payments for outside facilities with respect to usage by the prohibited group, since discrimination against the group appears to be acceptable. In fact, the statute is silent as to discrimination in benefits other than with respect to the twenty-five percent limitation.⁵³¹

One of the more confusing problems of interpretation is the interaction of the 25% test with the rule that a program will not fail to be qualified "merely because of utilization rates for the different types of assistance made available under the program."⁵³² Apparently the owner group cannot benefit unless employees also benefit. However, the utilization rate of different plan benefits is irrelevant.

Code section 129(e)(5) provides that business ownership for purposes of the 5% test will include constructive ownership.⁵³³ Stock ownership is to be determined under Code sections 1563(d) and (e) without regard to Code section 1563(e)(3)(C). Code section 1563(e)(3)(C) would otherwise disregard stock held by a tax-exempt employees' trust described in Code section 401(a). Ownership of unincorporated businesses is to be determined under similar rules to be developed by the Secretary of the Treasury, which rules will parallel the stock ownership tests.⁵³⁴

Section 129(d) states that the plan need not be funded in order

530. *Id.*

531. The proposed Technical Corrections Act, H.R. 6056, 97th Cong., 2d Sess. (1982), would prohibit discrimination in contributions or benefits in favor of employees who are officers, owners or highly compensated, or their dependents, in I.R.C. § 129(d). The wording would be similar to I.R.C. § 401(a)(4) with respect to qualified pension and similar plans and should be interpreted as requiring only that either contributions or benefits be nondiscriminatory. This language does not coordinate with I.R.C. § 129(e)(6) that availability of benefits rather than utilization is to be the appropriate test of discrimination.

532. I.R.C. § 129(e)(6) (West Supp. 1982).

533. *Id.* § 129(e)(5).

534. *Id.*

to be a qualified dependent care assistance program.⁵³⁵ However, the statute does not prohibit funding. If desired, funding may apparently be accomplished by means of a tax-exempt voluntary employees' beneficiary association qualified under section 501(c)(9) of the Code. Although it is presumed that Code section 162 is applicable, no guidance is given by Code section 129 or ERTA section 124 as to the deductible nature of the employer payments under the program. Similarly, no guidance is given concerning the deductibility of amounts paid into a trust for advance or level funding of the program. If advance funding is allowed, it would appear that the 25% test would continue to be applicable to employer contributions. Therefore, it would appear that not more than 25% percent of the amount an employer contributed for a year would be available to pay benefits to 5% or more owners, or their spouses or dependents. Similar language concerning funding of educational assistance programs under Code section 127(b)(5) appears, however, to have been interpreted by the IRS as prohibiting funding.⁵³⁶

The statute permits establishment of such a program by a sole proprietor, a partnership, or a corporation.⁵³⁷ The plan may cover self-employed individuals within the meaning of section 401(c)(1) of the Code.⁵³⁸ Thus, it appears that the intent was not to limit these programs to large organizations. The 25% test will, however, effectively exclude many small businesses if the owner is to be covered.

The dependent care assistance which may be excluded from the employee's income is that amount furnished or paid which, if paid for by the employee, would be considered an employment-related expense for which a tax credit is available under Code section 44A(c)(2).⁵³⁹ Such expenses are limited to expenses for household services and expenses for care of a qualifying individual which expenses are incurred to enable the taxpayer to be gainfully employed.⁵⁴⁰ A qualifying individual must be a dependent under age fifteen, or a spouse or other dependent who is physically or mentally unable to care for himself or herself during the

535. *Id.* § 129(d)(4).

536. Prop. Treas. Reg. § 1.127-2(c)(1) (1981). *Cf.* Prop. Treas. Reg. § 1.127-2(a) (1981).

537. I.R.C. § 129(e)(4) (West Supp. 1982).

538. *Id.* § 129(e)(3).

539. *Id.* § 129(e)(1).

540. I.R.C. § 44A(c)(2) (1976).

employment period. Expenses for the physically or mentally impaired spouse or dependent must be incurred in the taxpayer's household unless such spouse or dependent spends at least eight hours per day in the taxpayer's household.⁵⁴¹ The employee may not take a deduction or a credit for any amount excluded from his or her income under Code section 129.⁵⁴²

Code section 129 speaks only briefly about reporting and disclosure. As a condition of qualification, eligible employees must be given reasonable notification of the availability and terms of the program.⁵⁴³ Furthermore, by January 31 of each year, the plan must furnish employees with a written statement showing amounts paid or expenses incurred by the employer in providing dependent care assistance to the employee during the previous calendar year.⁵⁴⁴ Presumably, the standard IRS Form W-2 would be appropriate. In the case of a funded program, however, computation of the employer's expenditures with respect to an employee might become somewhat complex. Because the program appears to be an "employee welfare benefit plan" or "welfare plan," as those two synonymous terms are defined by section 3 of ERISA,⁵⁴⁵ it would appear that ERISA reporting and disclosure rules, including provision for summary plan descriptions and annual reports, would be required unless some exemption were available for the specific plan.⁵⁴⁶

Although the program is sponsored by the employer and might provide an equal cash or service benefit for each employee, the tax impact upon each employee may be quite different. The employee's exclusion for the taxable year cannot exceed the earned income of the employee if he or she is unmarried at the close of the taxable year.⁵⁴⁷ "Earned income" is defined by reference to Code section 43(c)(2) (employee compensation and net earnings from self-employment), but without regard to amounts paid or incurred by the employer for dependent care assistance to the employee.⁵⁴⁸ It would, therefore, be an unusual case in which this

541. *Id.* § 44A(c)(1), (c)(2).

542. I.R.C. § 129(e)(7) (West Supp. 1982).

543. *Id.* § 129(d)(5).

544. *Id.* § 129(d)(6).

545. ERISA § 3(1) (codified at 29 U.S.C. § 1002(1) (1976)).

546. For example, 29 C.F.R. § 2520.104-25 exempts day care centers from all ERISA reporting and disclosure requirements, except to provide "plan documents" to the Secretary of Labor upon request.

547. I.R.C. § 129(b)(1)(A) (West Supp. 1982).

548. *Id.* § 129(e)(2).

limitation would be meaningful. If the employee is married on the last day of the taxable year, the limitation is the earned income of the employee or his or her spouse, whichever is less.⁵⁴⁹ Thus, a nonworking spouse eliminates the exclusion in most cases. If the spouse is a full-time student or incapable of caring for himself or herself, an artificial earned income is created under the provisions of Code section 44A(e)(2).⁵⁵⁰ The artificial earned income for each month in which the spouse is a full-time student or incapable of caring for himself or herself is deemed to be (1) \$200 if there is one qualifying individual or (2) \$400 if there are two or more such individuals.⁵⁵¹ The exclusion will not be available if the amounts are paid to an individual with respect to whom the employee or spouse is entitled to a personal exemption deduction under Code section 151(e) (regardless of whether the exemption is utilized) or to a child of the employee (as defined in Code section 151(e)(3)) under the age of nineteen at the close of the taxable year (regardless of whether the exemption is available).⁵⁵² Congress has thus chosen not to allow the exclusion for payments to dependent parents, children, or others for taking care of one or more of a taxpayer's children.

Because of the expense necessarily involved both in establishing and maintaining a qualified written plan, and complying with the corresponding reporting and disclosure requirements of ERISA and the Code, one may question the worth of such a program to an employer or his or her employees in light of the tax credit provisions for dependent care under Section 44A of the Code. For employees in the lower tax brackets, the 30% credit may be of greater benefit than a 100% exclusion from income. Of course, even if the net economic impact were the same, the employer may prefer that it, rather than the government, receive credit for the benefit. Furthermore, for lower paid employees, the plan approach avoids the problem of under-utilization of credits by unsophisticated taxpayers.

For the more highly compensated employee, the advantages of the plan are more apparent. The credit, reduced for such employees to 20% of expenses,⁵⁵³ will rarely exceed the benefits of exclusion. Furthermore even as increased by ERTA, the amount

549. *Id.* § 129(b)(1)(B).

550. *Id.* § 129(b)(2).

551. *Id.* § 44A(e)(2).

552. *Id.* § 129(c).

553. *Id.* § 44A(a)(2).

creditable is limited to \$2,400 for one dependent or \$4,800 for two or more.⁵⁵⁴ Thus, a plan may provide greater tax-favored benefits per dependent and may cover more dependents than could be provided by the general tax credit. Furthermore, the statute does not preclude use of the tax credit to the extent the program is not utilized. Also, possibly subject to the 25% test, the plan becomes qualified on the basis of availability rather than utilization. If an employee does not wish to take advantage of the employer plan for tax or personal reasons, the employee can make his or her own arrangements and utilize the credit, possibly without jeopardizing the qualified status of the plan.⁵⁵⁵

These changes made by ERTA are generally applicable to taxable years beginning after December 31, 1981.⁵⁵⁶ The withholding, Federal Insurance Contributions Act, and Federal Unemployment Tax Act exclusions become effective with respect to any remuneration paid after December 31, 1981.⁵⁵⁷

E. *Extension of Qualified Group Legal Services Plans*

Code section 120, added by the Tax Reform Act of 1976,⁵⁵⁸ provides that amounts contributed by an employer on behalf of an employee or the employee's spouse or dependents to a qualified group legal services plan are not included in the gross income of the employee, the spouse, or the dependents. Similarly, the value of, or amount paid for, legal services under such a plan is also not included in the gross income of the employee, the spouse, or the dependents.⁵⁵⁹ A "qualified legal services plan" is defined in Code section 120 as a written plan of an employer for the exclusive benefit of its employees, or their spouses or dependents, the purpose of which plan is to provide personal legal services. The plan is required not to discriminate as to eligibility or benefits in favor of employees who are officers, shareholders, self-employed individuals, or highly-compensated persons.⁵⁶⁰

Certain provisions of the Tax Reform Act of 1976, as amended by the Revenue Act of 1978, stated that provisions as to the qualified legal services plans would end with taxable years ending prior

554. *Id.* § 44A(d).

555. However, see *supra* notes 527 and 531 and accompanying text.

556. ERTA § 124(f)(1).

557. *Id.* § 124(f)(2).

558. Pub. L. No. 94-455, 90 Stat. 1520 (1976).

559. I.R.C. § 120(a)(2) (1976).

560. *Id.* § 120(c).

to January 1, 1982.⁵⁶¹ ERTA section 802 extends such provisions to taxable years ending on or prior to December 31, 1984. Code section 120, however, is still not a permanent provision. Its temporary nature reflects a desire on the part of Congress for additional study regarding the effect and desirability of the section.

561. Revenue Act of 1978, § 703(b)(1), Pub. L. No. 95-600, 92 Stat. 2763, 2939 (amending Tax Reform Act of 1976, § 2134(e), Pub. L. No. 94-455, 90 Stat. 1520, 1928). -