Do Not Permit Deductible Employee Contributions Under Corporate Retirement Plans

By HOWARD L. SANGER and BRUCE GIVNER

According to the authors, with the exception of situations in which the sole shareholder of a company is also the sole employee and plan participant, employers should not amend their plans to permit qualified employee voluntary contributions because the disadvantages of such contributions far outweigh the advantages.

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Effective January 1, 1982, employers sponsoring pension and profit sharing plans may amend the plans to permit "qualified voluntary employee contributions" ("QVECs").[1]

Touted in the press as "deductible voluntary employee contributions," QVECs have provoked a great deal of interest among clients. The purpose of this article is to examine the new provision and show why it is not to be recommended in many situations.

I. *Prior Law*

Prior to ERTA, Section 219 did not permit deductions for an individual to an IRA if the individual was an "active participant" in a tax-qualified employee retirement plan.[2] Therefore,

[1] See P. L. 97-34 (popularly referred to as "ERTA" —the Economic Recovery Tax Act of 1981), Section 311, amending Internal Revenue Code Section 219.

[2] Prior to ERTA, Section 219(b)(2), "Covered by certain other plans," provided as follows:

> No deduction is allowed under subsection (a) for an individual for the taxable year if for any part of such year—
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> (A) he was an active participant in—
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> (i) a plan described in section 401(a) which includes a trust exempt from tax under section 501(a),
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> (ii) an annuity plan described in section 403(a),
>
> (iii) a qualified bond purchase plan described in section 405(a), or

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there were a large number of decisions dealing with what happens if an individual was almost covered, or covered by a plan for part of a year. Some of those decisions, such as *Gwenneth J. Ellor*,[3] went harshly against the taxpayer, while others attempted to assist the taxpayer where double tax benefits would not have resulted, such as *John F. Foulkes*.[4]

II. *ERTA Changes*

ERTA made three changes with respect to individual retirement accounts ("IRAs") that are relevant for purposes of the analysis in this article.

First, the deduction limits for IRAs were increased. For taxable years beginning after 1981, an individual can obtain a deduction for an amount not to exceed the lesser of (i) $2,000 (up from $1,500), or (ii) 100% (up from 15%) of the individual's earned income for the year. Of the two parts of the deduction limitation that were changed, clearly the more important was the latter: from 15% to 100%. Now an individual earning $2,000 can put the entire $2,000 into an IRA, as opposed to only $300 (15% of $2,000) under prior law.

Second, the old prohibition against deductions for IRA contributions for active participants in qualified plans was deleted.

Third, employers were given the opportunity to amend their plans to permit participants to make "qualified voluntary employee contributions" to those plans. However, between such voluntary contributions and an IRA, the participants cannot exceed the deduction limits described above ($2,000 or 100% of earned income).

As a result of these three changes, the public's interest in IRAs has increased dramatically. Now an employee may have the opportunity to provide for his or her retirement in an amount up to $2,000 each year in a tax-deductible fashion without worrying about whether he or she is an "active participant" in an employer's plan. Also, rather than going to a bank or to a savings and loan to open an IRA, employees can go to their employers and may be permitted to open so-called employee IRAs (we prefer to use the language of the Code, the acronym for which is "QVEC").

III. *Supposed Benefits of QVECs*

A number of advantages have been postulated on behalf of QVECs as compared with IRAs.

First, it is hoped that employer sponsorship will result in a higher rate of return on the dollars invested. This would be the consequence of higher interest paid for the larger amount of funds available from the commingling of what might otherwise be separate IRAs. Similar advantages due to the larger aggregate of funds are available for other investment media (i. e., negotiated stock brokerage commission discounts on larger stock transactions).

Second, employers are not likely to pass on the administrative costs to their employees, unlike banks and other common IRA trustees. (This advantage would be minimized if participant-directed programs, such as the one established by the Beverly Hills Bar Association, received greater publicity.)

Third, an employer-sponsored plan may be implemented through payroll deductions, which may be a relatively painless way for employees to help provide for their own retirement.

Fourth, sponsorship of such plans by employers would be a useful employee-relations tool.

Fifth, the status of the participant's account will be shown on the same statement on which the status the participant's other retirement accounts is shown. In other words, there would be less complication in dealing with one trustee (the employer) rather than two (the employer and a bank).

Sixth, unlike IRAs, which require commencement of distribution of a person's account at age 70½, there is no similar requirement for QVECs.

Seventh, and finally, a QVEC can be distributed in a lump sum as part of an estate tax-free distribution from a qualified plan. This is better treatment than is afforded IRA distributions, which will be subject to estate tax unless made over a period of at least 36 months.[5]

IV. *Disadvantages*

More than negating the advantages cited above are the following disadvantages:

First, if the employer determines the investment of the funds accumulated by QVECs, the

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(iv) a plan established for its employees by the United States, by a State or political subdivision thereof, or by an agency or instrumentality of any of the foregoing, or

(B) amounts were contributed by his employer for an annuity contract described in section 403(b) (whether or not his rights in such contract are nonforfeitable).

[3] CCH Dec. 37,791(M), 41 TCM 1184 (1981).

[4] 81-1 USTC ¶ 9149, 638 F. 2d 1105 (CA-7), rev'g CCH Dec. 35,585(M), 37 TCM 1851-47 (1978).

[5] Section 2039(e), "Exclusion of Individual Retirement Accounts."

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employer bears the risk of a public relations disaster if the rate of return is inferior to that which could easily have been achieved by the participant in a savings and loan or money market fund.[6]

Second, if the employer permits the participants to direct the investment of their own QVEC accounts, the resulting paperwork will cause large administrative expenses and headaches for the employer.

Third, payroll deductions, if utilized, may cause employees to request pay increases to offset the deductions.

Fourth, new Section 219(f)(4), entitled "Reports," provides that the Secretary of the Treasury will promulgate regulations to prescribe the "time and manner" in which reports shall be made to the Government and to the participants by plans permitting QVECs. This additional paperwork would be an unwelcome addition to what is already a paperwork nightmare with respect to plan reporting requirements.

Fifth, new Section 6652(h), entitled "Information Required in Connection with Deductible Employee Contributions," provides a penalty of $25 per participant per year, not to exceed $10,000, for employers that fail to provide the reports referred to above.

Sixth, there will be increased legal fees. The legal fees will result from the necessity to amend the plans and summary plan descriptions to refer specifically to QVECs as being available.[7]

Seventh, and finally, because of the necessity to assemble the information required to complete the reports, there will be increased plan consulting fees. Plan consulting fees should also be increased to reflect the added likelihood of being forced to pay penalties on behalf of disgruntled employer clients who fail, because of the plan consultants' alleged negligence, to supply the reports required under the new law. If the employer retains an outside plan consulting firm, the additional plan consulting fees will be manifested in the consultant's bill each year to the employer. If the employer handles the plan administration work in-house, there will be more time spent by the employer's staff keeping track of the plan information.[8]

V. *The Best Situation for a QVEC*

It can be recommended that the employer's plan be amended to permit QVECs in situations in which the sole shareholder of a company is also the sole employee and sole plan participant: in other words, prototypically, in the case of professional corporations with one shareholder-employee. Although the first four "supposed benefits" cited earlier would not apply in this situation, there would be the advantage of putting another $2,000 into the same vehicle that is already being used for tax-qualified employee retirement benefits.

However, even in this situation, in light of Section 414(m), entitled "Employees of an Affiliated Service Group," there may be complications. For example, if the plans of the separate professional corporations permit QVECs and the plan of the super-entity (the so-called "core plan")

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[6] This brings to mind the point that the so-called public relations advantage of QVECs is not likely to be very attractive to many closely held and personal service corporations. Many such corporations have a tendency to view the whole area of tax-qualified employee retirement plans simply as an income tax planning device for the shareholder-employees.

[7] Section 219(e)(2)(A)(i) refers to a qualified employer plan "which plan allows an employee to make contributions which may be treated as qualified voluntary employee contributions under this section. . . ." That language suggests that plans should be amended to reference specifically the language of the new law rather than attempt to rely on existing plan language regarding voluntary employee contributions.

However, at the mid-winter meeting of the American Bar Association Section of Taxation Employee Benefits Committee in Orlando, Florida, February 12-14, 1982, a representative of the Tax Legislative Counsel's office indicated that a notice would be forthcoming on or about March 1, 1982, regarding the changes wrought by ERTA. This notice will indicate that existing plan language may suffice. As of the time that this article was prepared, the notice (ERTA-1) had not yet appeared. Therefore, this information is from notes taken at that Tax Section meeting: if there is no voluntary employee contribution language already in the employer's plan and the employer wishes to permit QVECs, the plan must be amended and submitted to the IRS for a favorable determination letter. If there is voluntary employee contribution language in the employer's plan and the total voluntary employee contributions (QVEC and other) are not intended to exceed 10% of compensation, the plan need not be amended and need not be submitted for a new favorable determination letter. To take advantage of the existing plan language, the employer would simply have to give notice to the employees. However, if there is existing plan language and it is intended that the QVECs plus other employee contributions be permitted to exceed 10% of compensation, the plan must be amended and submitted to the IRS for another favorable determination letter.

Notwithstanding comments by the Tax Legislative Counsel's office that existing plan language regarding voluntary employee contributions may in some cases suffice for QVECs, such reliance would seem to be fraught with difficulties.

[8] If a client does the plan administration work in-house, can the practitioner be comfortable with the thought of the in-house staff's ability to account separately for contributions coming in weekly, bi-monthly, monthly, etc., crediting interest to the various employees' accounts and knowing exactly what the accounts are worth each year?

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does not permit QVECs, is the core plan for that reason alone not comparable to the plans of the separate corporations?[9]

VI. *Conclusion*

In most situations employers should not amend their plans to permit QVECs because the disadvantages of allowing such contributions far outweigh the advantages.[10] Instead, employees wishing to provide another $2,000 per year on a tax-deductible basis for their retirement should be directed to one of the increasing number of trustees that will permit individuals virtually to direct the investment of their IRA funds. ●

[9] For more background on the problems raised by Section 414(m), see any one of the following articles: McClure and Widlus, "Practical Safe-Harbor Provided for Determining When Related-Employer Plans are 'Comparable,'" 27 *Taxation for Accountants* 298 (1981); Givner, "IRC Section 414(m): IRS' Pro Rata Approach for Plan Years Prior to Its Effective Date," 7 *Journal of Pension Planning and Compliance* 456 (1981); Gehring, "Rev. Rul 81-105 and the Use of Professional Service Corporation Partnerships After the Enactment of Sec. 414(m)," 59 TAXES—*The Tax Magazine* 371 (June, 1981); Givner, "Revenue Procedure 81-12: IRS Gives More Time to Solve Problems Raised by New Pension Law," 81 *Los Angeles Daily Journal Reports* 21 (May 29, 1981); Scudere, "What Has to Be Done to Keep Kiddie-Garland Type Plans Qualified Under IRS' 'Best Plan' Approach," 7 *Journal of Pension Planning and Compliance* 231 (1981); Neal and Conway, "New Section 414(m) Limits Qualified Plan Abuse by Affiliated Service Organizations," 54 *Journal of Taxation* 258 (1981).

[10] Admittedly, this analysis is from the perspective of closely held corporations and personal service corporations. In corporations with many employees, the balance may tip in favor of QVECs due in part to economies of scale and already established payroll-deduction plans.

Taxpayer Education and Your Business Tax Kit Programs Updated

The Internal Revenue Service has revised its Taxpayer Education Handbook by providing a new list of Taxpayer Education Program objectives for fiscal year 1982 that will receive primary emphasis and by updating procedures to the format of Your Business Tax Kit Program (IRS Publication 454).

The special needs of individual taxpayers will be met by the following seven Taxpayer Education programs: (1) Volunteer Income Tax Assistance (VITA); (2) Understanding Taxes; (3) Student Tax Clinics; (4) Small Business Workshops (SBW); (5) Practitioners Institutes; (6) Tax Counseling for the Elderly; and (7) Magnetic Media. Two programs included in the 1980 fiscal year objectives, Fundamentals of Tax Preparation/Individual Tax Education Workshops, and Tax Education Audio Program, were not included in this year's list of primary objectives.

The Small Business Workshop Program and Your Business Tax Kit Program (YBTK) are designed to help new business taxpayers understand federal tax requirements. In certain circumstances, when attendance at IRS-sponsored workshops is not feasible, the Small Business Tax Kit Program should assist taxpayers by providing sample copies of appropriate business forms and publications in an envelope-type format. Starting with the 1982 fiscal year, individual YBTK counseling sessions either at an IRS office or at the taxpayer's place of business will not be held. However, counseling may still be given in cases where five or more business persons are present in an IRS office at one time; in these instances it would not be practical to hold a full session workshop. (IRM 6570, Secs. 340, 530.)—CCH INTERNAL REVENUE MANUAL — ADMINISTRATION REPORTS, No. 147, March 9, 1982.

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