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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

May 20-21, 2005

*The preceding questions and answers are based on an oral presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee meeting on May 21, 2005. The questions were submitted by ABA members, and the responses were given at such meeting after explicit statements that their responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the responses was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting and on a review of audio tapes of the meeting. This report has not been reviewed by IRS or Treasury.*

## 1. Separate Identification Number for Plan Trust

What is the IRS's current position on the use of separate ID numbers for the trust of a qualified plan? In the past, employers used form SS-4 to request a TIN for the trust. This number was used for the trust investments and tax reporting of distributions and tax withheld from the trust and was distinct from the EIN used to identify the employer. The separate trust TIN was also reported on the Form 5500 Schedule P. On several separate occasions recently, the IRS has stated that the TIN for the trust should be the corporate EIN number followed by the letter "P". Has there been some change in the IRS protocols related to TINs?

**Proposed Response:** It is less confusing to have a separate trust TIN.

**IRS response:** All trusts of qualified plans must apply for a TIN distinct from the employer's TIN. It has never been the IRS position that a trust could simply affix the letter "P" to the employer's EIN to identify the trust, although there was an internal policy for IRS research purposes only, not for official reporting requirements.

## 2. §72(p) – Plan Loans

Treas. Reg. 1.72(p)-1, Q&A-19(b)(2) imposes an additional security requirement for a plan loan initiated on or after January 1, 2004, if the borrower at the time the new loan is requested has a previous plan loan that was deemed distributed and has not been repaid (such as by plan loan offset). The additional security requirement may be satisfied by having an arrangement requiring repayments be made by payroll withholding. If at any time before full repayment of such loan the additional security requirement is not satisfied (for example, the borrower revokes consent to payroll deduction), the outstanding balance of such plan loan at the time the additional security requirement is not satisfied will be treated as a deemed distribution under §72(p).

1. Will the outstanding balance of a plan loan that requires additional security under Treas. Reg. 1.72(p)-1, Q&A 19(b)(2) be treated as a deemed distribution at the time the additional security requirement is not satisfied if the previous plan loan that resulted in a deemed distribution is repaid before the time that the additional security requirement is not satisfied? In other words, does the additional security requirement continue to apply to a plan loan after the previous loan that resulted in a deemed distribution is repaid?

2. May a plan administrator extend/offer a cure period (to repay the outstanding balance of a plan loan) to a borrower with a plan loan (that requires additional security under Treas. Reg. 1.72(p)-1, Q&A 19(b)(2)) that later fails to meet the additional security requirement before treating the outstanding balance of such plan loan as a deemed distribution?

3. For a plan that only allows the additional security requirement under Treas. Reg. 1.72(p)-1, Q&A 19(b)(2) to be met by a payroll deduction arrangement, will the outstanding balance of a plan loan that requires additional security be treated as a deemed distribution for a borrower on an unpaid leave of absence at the time the loan repayments can no longer be suspended (i.e. the unpaid leave of absence extends beyond one year)?

**Proposed Response:**

1. No. The additional security requirement under Treas. Reg. 1.72(p)-1, Q&A 19(b)(2) will no longer need to be satisfied for a plan loan if the previous loan that resulted in a deemed distribution has been repaid since the borrower may request a new loan or a refinancing and not have the additional security requirement apply.

2. Yes. The plan administrator may extend a cure period (to repay the outstanding balance of a plan loan) to a borrower with a loan (that requires additional security under Treas. Reg. 1.72(p)-1, Q&A-19(b)(2)) at the time the additional security requirement is not met before treating the outstanding balance as a deemed distribution.

3. No. The additional security requirement will be considered satisfied because the payroll deduction arrangement is still in place. The fact that payments cannot be made via payroll deduction because the employee does not have compensation paid to him or her for a particular period of time does not violate the additional security requirement provided that there is an expectation that the employee will return from the leave of absence and receive compensation from which to make future loan repayments.

**IRS response:**

1. The additional security requirement continues to apply after the repayment of the first loan and until the time of the repayment of the second loan.

2. There is no cure theory that applies. The plan must continue to satisfy the security requirements until the repayment of the second loan.

3. The additional security requirement is considered as satisfied because the payroll system is still in place. The mere fact that the participant is on unpaid leave does not cause a violation of the additional security requirement.

**3. §72(t) – Early Distribution Penalty Tax: Substantially Equal Periodic Payments**

Can a taxpayer who changes to the RMD method also change the life expectancy table used to calculate the amount of the distribution?

Rev. Rul. 2002-62 provides various rules for when taxpayers may select a different life expectancy table to use in calculating their distributions. Section 2.02(a) states that “in the case of the required minimum distribution method, the same life expectancy table that is used for the first distribution year must be used in each following year.” Thus, if the taxpayer uses the single life expectancy table for the required minimum distribution method in the first distribution year, the same table must be used in subsequent distribution years.

The language in section 2.02(a) suggests that the rule does not apply to someone who is changing from the amortization or annuitization method to the required minimum distribution (“RMD”) method, i.e., someone making such a change can also choose to calculate distributions under a different life expectancy table. Section 3 states that “if a series of payments commenced in a year prior to 2003 that satisfied § 72(t)(2)(A)(iv), the method of calculating the payments in the series is permitted to be changed at any time to the required minimum distribution method described in Section 2.01(a) of this guidance, including use of a different life expectancy table.” No rule is expressly provided, however, for taxpayers whose series of payments commences after 2002 and who subsequently change to the RMD method.

**Proposed Response:** Taxpayers (including those whose series of payments began after 2002) who make a change from either the amortization or the annuitization methods to the RMD method can also choose to calculate distributions under a life expectancy table that is different than the one used under the amortization or annuitization method.

**IRS response:** The IRS disagrees with proposed response. The fact that the Revenue Procedure has a special rule for distributions before 2003 indicates both that the special rule does not apply

for distributions after 2002 and that different treatment than the special rule is required. The general rule permits changing method, but not the life expectancy table.

#### **4. §72(t) - Early Distribution Penalty Tax: Substantially Equal Periodic Payments**

Can a taxpayer calculate a distribution on a fiscal year basis?

With respect to the RMD method, Rev. Rul. 2002-62 states that, once an election to change from either the amortization or the annuitization method to the RMD method has been made, the newly-elected RMD method must be followed in remaining years. The revenue ruling does not impose any limitations on the time when an election can be made.

With respect to the amortization and annuitization methods, the IRS has permitted taxpayers to calculate the payments by amortizing the balance of the account over the taxpayer's life expectancy multiplied by the number of years or corresponding number of months in the applicable payment period. Under these rulings, if a taxpayer elected to take substantially equal periodic payments under the amortization method by amortizing the account balance over the corresponding number of months in the taxpayer's life expectancy, the payments were deemed to constitute a series of substantially equal periodic payments; provided, however, that the monthly payments continued for the required payment period determined on either a calendar or fiscal year basis. For example, suppose that Taxpayer C calculates substantially equal periodic payments using the amortization method and determines that she should receive \$12,000 per year or \$1,000 per month for each month in the life expectancy period. If Taxpayer C begins receiving payments in November 2004, she would receive \$1,000 per month in November 2004 and December 2004, i.e., \$2,000 for calendar year 2004.

**Proposed Response:** Taxpayers may calculate distributions on a fiscal year basis.

**IRS response:** The IRS agrees with proposed response. Section 2.02(d) of Rev. Rul. 2002-62 allows the use of any 12-month period to determine the account balance as long as it is reasonable under the facts and circumstances. But once a period is selected, it must be consistently used.

#### **5. §72(t) – Early Distribution Penalty Tax: Substantially Equal Periodic Payments**

Can a taxpayer take annual distributions under the RMD method at any time during a calendar year?

Section 2.01 of Rev. Rul. 2002-62 states that “payments are considered to be substantially equal periodic payments within the meaning of § 72(t)(2)(A)(iv) if they are made in accordance with one of the three calculations described in paragraphs (a)-(c) of this subsection (which is comprised of the three methods described in Q&A-12 of Notice 89-25). Notice 89-25 states that a payment will be considered a substantially equal periodic payment if it is “determined using a method that would be acceptable for purposes of calculating the minimum distribution required under section 401(a)(9).”

Rev. Rul. 2002-62 and its reference to Notice 89-25 suggest that a taxpayer can take each year's distribution at any time during the distribution year in the same manner as is permitted under Code section 401(a)(9). Thus, a taxpayer may take the distribution in January of Year 1, November of Year 2 and in June of Year 3.

**Proposed Response:** A taxpayer may take an annual distribution at any time during a calendar year, provided that a distribution is taken each year.

**IRS response:** The IRS agrees with proposed response. The IRS notes that if the taxpayer is not using a calendar year the annual distribution can be made at any time during the 12 month period being used to determine minimum distributions.

## **6. §125 – Cafeteria Plans**

Company X maintains a §125 cafeteria plan for the benefit of its active employees (and employees of its affiliates) which has both a medical flexible spending account as well as a dependent care flexible spending account. Company Y maintains a §125 plan for the benefit of its active employees (and employees of its affiliates) which has both a medical flexible spending account as well as a dependent care flexible spending account. During 2004, Company X buys the stock of Company Y-8, a subsidiary of Company Y which participates in the Company Y §125 Plan. In order to facilitate the transition of the Company Y-8 employees into its payroll, Company X agrees to allow the Company Y-8 employees who elected to participate in Company Y's flexible spending accounts to have the same level of coverage under Company X's 125 plan so that their participation will be treated as continuous from the beginning of Company Y's plan year. The Company Y-8 employees' salary reduction elections will be treated for the remainder of Company X's plan year as if they had been made under Company X's flexible spending accounts. Company X agrees to make appropriate amendments to its cafeteria plan.

Does the holding of Revenue Ruling 2002-32 Situation (2) apply in the context of a sale of the stock of a subsidiary?

**Proposed Response:** Yes. The holding of Rev. Rul. 2002-32 was predicated upon there being no loss of eligibility for coverage under Treas. Reg. 1.125-4.

**IRS response:** The IRS agrees with proposed response. The holding of Rev. Rul. 2002-32 will work in a stock sale for the buyer to step into the shoes of seller.

## **7. §152 – Definition of Dependent**

The effect of the use of the term “dependent” under §152 effective 1/1/05 is that certain benefits for dependent children who are full time students who attain the age of 24 at any time during 2005 may become taxable to the employee. For example, under a health insurance plan, benefits paid on behalf of dependents are generally non-taxable under §105. Section 105(b) refers to dependents as defined in §152.

Many health plans are designed to provide that a dependent child who is a full time student may continue to be covered under the health insurance policy until the child's 24<sup>th</sup> birthday. Other policies will allow coverage for the remainder of the policy year in which the dependent attains age 24.

Even though policies may continue to provide such coverage, it appears that under the revised rules for determining who is a dependent, amounts paid out of a health plan on behalf of a child who is a full time student will become taxable to the employee in the year in which the child attains age 24.

The same effect appears to apply to qualified tuition reduction plans under §117(d).

The question is whether this is the correct application of the revised definition of dependent and whether there is any consideration to extending the period for which the full time students could continue to receive these benefits on a tax-free basis until at least their 24<sup>th</sup> birthday.

**Proposed Response:** None.

**IRS response:** Dependent status is an “on or off switch” for the year. An individual who turns 24 in a year will not be considered a dependent child for that entire year. The individual may still be a dependent as a dependent relative based on the facts and circumstances of the situation.

## **8. §152 – Definition of Dependent**

Section 105(b) requires that for amounts paid under an employer sponsored group health plan for an employee’s dependents to be excluded from the employee’s gross income, the dependent must meet the qualifications of §152. Under the Working Families Tax Relief Act of 2004, the definition of qualified child requires that the individual share the same principal place of abode as the taxpayer (§152(c)(1)(B)) and who has not provided for more than one-half of his/her own support (§153(c)(1)(D)). This limitation on the eligibility of dependent children applies to group health plans, health care flexible spending accounts and health reimbursement accounts.

The Omnibus Budget Reconciliation Act of 1993 (OBRA ’93) amended the Social Security Act to require that states amend their laws so that insurers (and for the purposes of this provision ERISA plans were included within the definition of insurers (see 42 USC §1396g-1(b)), were prohibited from denying enrollment under a parent’s health care coverage on the grounds that: (a) the child was born out of wedlock, (b) the child is not claimed as a dependent on the parent’s federal income tax return, or (c) the child does not reside with the parent or in the insurer’s service area. On information and belief, all 50 states have passed such laws.

These requirements appear to be conflict because in order for a dependent child to be entitled to receive health care coverage under an employer-sponsored plan or arrangement on a tax-qualified basis, he or she must qualify as a dependent under §152 and/or be claimed as a dependent on the taxpayers income tax returns, while the state laws mandated by OBRA ’93 expressly prohibit insurers, including ERISA-regulated plans, from imposing these requirements in order for children to be eligible for coverage under their parents’ health care coverage.

**Proposed Response:** While it is possible to resolve this apparent conflict by allowing children that do not qualify as tax dependents under §152 to be eligible for health care coverage under their parents’ coverage, but to include the cost of such coverage and any amounts expended for medical expenses on their behalf in their parents’ gross income, the better solution would be for natural born and adopted children, and children for whom the taxpayer is the legal guardian, to be eligible for coverage under an employer-sponsored plan for the reasons set forth in OBRA ’93 and to have the amounts paid on their behalf be excluded from the gross income of their parents.

**IRS response:** The IRS disagrees with proposed response. If the individual is not a dependent for federal tax purposes, the benefit is taxable even if state law requires coverage.

## **9. §223 - Health Savings Accounts**

Assume an employer desires to make employer contributions to an employee’s Health Savings Account (HSA) if the employee participates in the high deductible health plan (HDHP) sponsored by the employer under the comparability rules and further desires to limit the contributions to a single provider. May an employer provide that an employee will not be eligible to participate in the self-insured HDHP if he or she does not establish an HSA account with the designated provider but instead establishes an account with an alternate provider? Note that there would be

no prohibition against establishing two HSA accounts or rolling contributions made to the designated provider into the second account.

**Proposed Response:** The proposed eligibility provisions are consistent with current law. The HDHP would be treated as currently and effectively available to all employees for purposes of §105(h) and contributions would be made to the HSA accounts of all employees participating in the HDHP in accordance with the comparability rule.

**IRS response:** The IRS agrees with proposed response that this is not a HSA violation, but noted it could be a significant violation of section 105 because the HDHP excludes from participation a group of employees that is not described in section 105(h)(3)(B).

#### **10. §223 - Health Savings Accounts**

Will the transition rule for prescription drug plans be extended?

**Proposed Response:** Yes. For 2006, coverage by a prescription drug plan that does not qualify as a high-deductible plan will not make the participant lose HSA eligible status.

**IRS response:** The IRS disagrees with proposed response.

#### **11. §223 - Health Savings Accounts**

Are all HSA contributions made by an employer reported on the W-2 as employer contributions when (a) made from employee contributions deducted pursuant to a cafeteria plan election and (b) made by the employer outside of §125 under the comparability requirements?

**Proposed Response:** Yes. All employer contributions are reported on the employee's W-2.

**IRS response:** The IRS agrees with proposed response.

#### **12. §223 - Health Savings Accounts**

If an employer makes excess HSA contributions for an employee in the following situations, what are the ramifications for the employer and employee? (a) Employer pre-funds contributions (with pro-rated contributions made for employees who enroll later in the year to meet comparability requirements) and employee's coverage ends while the pre-funded contributions exceed the deductible limit based on the employee's months of coverage; (b) employee is not eligible for HSA contributions due to non-qualifying coverage outside of the employer.

##### **Proposed Response:**

Impact on the employer - The excess contribution may not be deducted from the employee's HSA without violating the non-forfeiture requirement. The excess is taxable compensation subject to the withholding and reporting requirements for federal income and FICA taxes. If the employer has not withheld the appropriate taxes from the employee, the employer must fund the tax liability.

Impact on employee - The employee must include the excess contribution in taxable income. If not refunded from the HSA prior to the employee's income tax filing deadline, the excess

contribution may be subject to the 6% excise tax. (Note that this result would not necessarily flow from the current presentation on Form 8889).

**IRS response:** For the impact the employer, the IRS agrees with the proposed response. The HSA nonforfeiture rules bar an employer from withdrawing contributions from an employee's HSA. The employer may have a reasonable belief when the amounts are contributed that the employer's contributions to the HSA are excluded from employment tax. The employee would have the responsibility to withdraw the funds from the HSA and satisfy any tax obligations.

For the impact on the employee, the IRS agrees with the proposed response. If not withdrawn from the account by the tax filing deadline, the employee must include the excess contribution in taxable income and may be subject to the 6% excise tax. The IRS believes this result follows the instructions on Form 8889, pages 4 and 5.

### **13. §223 - Health Savings Accounts**

Is the Service considering allowing an HSA participant who is otherwise eligible to file Form 1040EZ to also file Form 8889 to report HSA contributions and distributions?

**Proposed Response:** The Service is considering allowing an HSA participant to continue to file Form 1040EZ if he or she does not intend to deduct contributions to the HSA for the tax year (because no contributions were made, because contributions were made by the individual's employer, or because the individual chooses to forgo the deduction) and any distributions were made to reimburse medical expenses. However, a Form 8889 must be filed by such participants with their Form 1040EZ's.

**IRS response:** The IRS disagrees with proposed response. Form 1040EZ or 1040A are designed to be filed without attachments, so a taxpayer cannot use Form 8889 if they are filing such forms.

### **14. §223 - Health Savings Accounts**

Will the Service consider allowing a participant who is receiving VA medical benefits to be treated as HSA eligible?

**Proposed Response:** A wide variety of former service members are entitled to VA medical benefits. VA medical benefits cover service-related conditions. In addition, some low income individuals and individuals with service connected illnesses or injuries may qualify for various levels of coverage for other conditions depending on the service connected status (0% to 100%). Note that VA coverage would pay secondary to all other plans for non-service related coverage. For most former service members, VA medical benefits are more like specific injury insurance or other limited scope insurance. In such cases, it would be appropriate to treat individuals receiving VA benefits as HSA eligible individuals.

**IRS response:** The IRS disagrees with proposed response. Q&A 5 of Notice 2004-50 indicates that an individual who has received medical benefits from the VA at any time during the previous three months is not an eligible individual, and the IRS has no plans to change that response.

### **15. §401(a) – Allocation of Forfeitures**

Employer A maintains a single employer union negotiated defined benefit plan. In negotiations, the union declines to accept the plan provision that forfeitures cannot be used to increase benefits. Is the union correct in its stand?

**Proposed Response:** Possibly yes. In private advice, the IRS has, before ERISA's passage, advised local offices to approve union negotiated plans that do not provide for the prohibition of increasing benefits by forfeitures. Perhaps the solution is to provide that if assets remaining in the plan fully fund all accrued benefits, the excess will be applied to provide additional benefits for the employees.

**IRS response:** The IRS disagrees with proposed response. Section 401(a)(8) requires that forfeitures under a defined benefit plan may not be applied to increase the benefits of any employee, and there is no exception for collectively bargained plans.

#### **16. §401(a) – Employer Contributions**

A plan sponsor decides to change record keepers. The old record keeper informs the plan sponsor that there is a surrender charge to transfer the plan assets to the new record keeper. If, instead of charging the surrender charge to the accounts of the plan participants, the old record keeper charges the plan sponsor directly, and the plan sponsor pays the surrender charge directly to the old record keeper, is the payment considered an employer contribution subject to testing under §415 and §401(a)(4)?

**Proposed Response:** No. Since no money was deposited by the plan sponsor into the plan, no contribution has been made.

**IRS response:** The IRS agrees with proposed response for this fact pattern, but is not willing to give a blanket endorsement to the proposed rule that since no money was deposited by the employer to the plan, no contribution has been made. It is a facts and circumstances determination whether a contribution has been made.

#### **17. §401(a)(4) – New Comparability Requirements for Cross-tested Defined Contribution Plans**

Can a defined contribution plan satisfy the smoothly increasing schedule of allocation rates standard under the new comparability rules if allocations are fixed dollar amounts instead of specified percentages of pay? For example, assume a plan provided a fixed \$100 allocation for all participants under age 25, with the allocation increasing by \$100 for every 5 year age band thereafter so that participants aged 26 to 30 receive \$200, participants age 31 to 35 receive \$300, and so on.

**Proposed Response:** Yes. According to Treas. Reg. 1.401(a)(4)-2(c)(2)(i), allocation rates may be expressed either as a percentage of plan year compensation or as a dollar amount. While the schedule of increasing dollar amount allocations does not appear to satisfy the requirement that allocation rates increase by no more than 5 percentage points, since it is not clear how that restriction would apply at all to dollar amount allocation rates, the schedule does satisfy the other requirements to be considered a smoothly increasing schedule of allocation rates. The ratio of any allocation rate to the immediately preceding allocation rate is not more than 2.0, nor does it exceed the ratio allocation rates between any two immediately preceding bands. The described schedule of dollar amount allocations should be considered as smoothly increasing under the gradual age or service new comparability standard.

**IRS response:** The IRS disagrees with proposed response. The new comparability rules do not provide for a schedule of allocation rates that are a fixed dollar amount, so such a plan cannot be cross-tested under the nondiscrimination rules.

#### **18. §401(a)(4) – Nondiscrimination Testing: Tie between Average Benefit Percentage Test and General Test**

Both the Average Benefit Percentage Test and the General Test require calculation of employee benefit percentages. Must the employee benefit percentages used for the General Test be calculated in the same manner (benefits versus contributions basis) as for the Average Benefits Percentage Test?

For example, would this be required when using the optional rule under Treas. Reg. 1.410(b)-(5)(e)(3)? Under this rule, if both DB and DC plans exist in the controlled group, the ABPT may be performed separately for the DB plans and the DC plans. The regulation says “employee benefit percentages under all defined contribution plans in the testing group must be determined on a contributions basis” and “all defined benefit plans in the testing group must be determined on a benefits basis.”

**Proposed Response:** It is not necessary to use the same calculation options for the ABPT and the General Test. The requirements in Treas. Reg. 1.410(b)-(5)(e)(3) that apply when using the separate test option for the ABPT do not extend to the General Test.

**IRS response:** The IRS agrees with proposed response.

#### **19. §401(a)(9) – Required Minimum Distributions**

Plan A offers several optional forms of benefit, including joint and 100% survivor, joint and 2/3 survivor, and joint and 1/2 survivor options. In addition, Plan A offers a partial lump sum option ("PLSO"), which permits a member to choose an immediate lump sum in an amount equal to 1 year, 2 years, or 3 years worth of a pension, with an actuarially reduced annuity benefit. The actuarially reduced annuity may contain a survivor portion in the form of a joint and 100% survivor option, joint and 2/3 survivor, or joint and 1/2 survivor option. Members may designate the beneficiary, including a non-spouse beneficiary, for either the standard joint and survivor option or joint and survivor option with a PLSO.

If a member selects a non-PLSO joint and survivor option and designates a non-spouse beneficiary, the minimum distribution incidental benefit ("MDIB") rules are applied based on the adjusted employee/beneficiary age difference rules contained in Treas. Reg. 1.401(a)(9)-6, Q&A-2(c). However, if a member selects a PLSO option and designates a non-spouse beneficiary for the annuity portion, should the MDIB rules be applied to the annuity portion of the PLSO payment without regard for the PLSO lump sum payment to the member? Or, should the MDIB test be actuarially adjusted to take into account the PLSO lump sum payment?

**Proposed Response:** The purpose of the MDIB test is to ensure that the primary use of qualified plan benefits is to fund the retirement benefits of the employee. Therefore, if a PLSO option is selected, before testing the annuity benefits paid in addition to the PLSO lump sum, the amount of the PLSO lump sum should be converted into the actuarial equivalent of a single life annuity for purposes of the MDIB test in order to take into account the full value of retirement benefits paid to the employee.

For example, assume that the adjusted employee/beneficiary age difference is 28 years according to the methodology in Treas. Reg. § 1.401(a)(9)-6, Q&A-2(c). If a non-PLSO survivor benefit were elected, the maximum survivor benefit percentage that could be paid would be 62%. Therefore, this member could not elect a non-PLSO joint and 2/3 survivor option.

However, the MDIB rule for the PLSO option should take into account the value of the PLSO lump sum. Assume the member elected the PLSO option to receive a \$15,000 PLSO lump sum, chose a joint and 2/3 survivor option for the remaining annuity, and designated the same non-spouse beneficiary for the remaining annuity. Assume that the amount of the member's annuity is \$1,000, with the survivor benefit equal to \$666.67. If the \$15,000 lump sum is converted to a single life benefit payable to the member, assume it is the actuarial equivalent of \$100/month. Because the adjusted employee/beneficiary age difference is 28 years according to Treas. Reg. § 1.401(a)(9)-6, Q&A-2(c), then the applicable percentage that may be paid to the beneficiary may not exceed 62%. Without taking into account the PLSO lump sum, the survivor benefit exceeds this percentage (66 2/3% exceeds 62%). However, if the PLSO lump sum is considered in addition to the member's benefit in order to test for compliance with the MDIB test (by considering it as a single life annuity benefit paid to the member and considering the member's benefit to be \$1,100, which is the monthly benefit of \$1,000 plus the \$100 equivalent of the lump sum), then the actual value of the benefit to the survivor is calculated as  $\$666.67 / \$1,100 = 61\%$ .

**IRS response:** The IRS disagrees with proposed response. Prior lump sum distributions cannot be credited against subsequent required minimum distribution requirements. The required minimum distribution regulations permit recognizing commencement of benefit prior to the participant's required beginning date, but there were no comments suggesting crediting lump sum distributions against subsequent survivor annuity benefits. If the participant were to roll over the lump sum distribution, it could be distributed over a longer period than the total benefit amount should have been distributed if paid entirely as a joint and survivor annuity.

## **20. §401(a)(9) – Required Minimum Distribution: Designated Beneficiary**

Employee X is a participant in a governmental defined benefit plan (Plan Z) established by Employer Y. Employee X retires, chooses to receive benefits in the form of a joint and survivor annuity and designates his wife as the beneficiary. Two years later, Employee X's wife dies. Plan Z provides that Employee X may designate a substitute beneficiary. Employee X designates a new beneficiary and Plan Z recalculates his benefit on the basis of his and the new beneficiary's lives. Depending on the life expectancy of the new beneficiary chosen, the annuity payments to Employee X and the annuity period might either increase or decrease.

Where a governmental plan permits a retiree taking benefits in the form of a joint and survivor annuity to designate a substitute beneficiary when the initial beneficiary predeceases retiree, are there any limitations on whom the retiree may designate? In particular, does the designation of someone other than a spouse violate the rules under Treas. Reg. 1.401(a)(9)-6, Q&A-13 and -14 limiting the circumstances in which annuity payments and the period of an annuity may change?

Treas. Reg. 1.401(a)(9)-6, Q&A-13 provides that an annuity payment period may change only in limited circumstances. In particular, an annuity payment period may be changed (and the annuity payments modified as a result) only: (i) in connection with the employee's retirement or a plan termination; (ii) where the previous form of the annuity payments was a period certain with no life contingencies; or (iii) where the payments are changed as a result of the employee's marriage to a qualified joint and survivor annuity over the joint lives of the employee and the employee's new spouse.

In addition, an annuity payment period may change in connection with a permitted increase in annuity payments pursuant to Treas. Reg. 1.401(a)(9)-6, Q&A-14. Annuity payments are permitted to increase in the following circumstances: (i) annual percentage increases which do not exceed an eligible cost of living index; (ii) percentage increases occurring at specified times which do not exceed the cumulative total of increases per an eligible cost of living index; (iii) to adjust for the elimination of the reduction in the employee's payments for a survivor benefit, where the survivor predeceases the employee or is no longer the beneficiary per a QDRO; (iv) to pay increased benefits resulting from a plan amendment; or (v) to convert a survivor portion of a joint and survivor annuity into a lump sum distribution upon the employee's death. In addition, the following increases are permitted with respect to an annuity contract purchased from an insurance company: (i) annual (or less frequent) increases by a constant percentage; (ii) a final payment upon death of the employee in the amount of the total value less payments made; (iii) due to dividend payments or other payments resulting from actuarial gains; and (iv) an acceleration of payments under the annuity. The following additional increases are permitted for annuity payments from a qualified trust: (i) annual (or less frequent) increases by a constant percentage of less than five percent per year; (ii) a final payment upon death of the employee in the amount of the total value less payments made; and (iii) increases due to dividend payments or other payments resulting from actuarial gains.

The factual scenario set forth above does not fall within any of the situations in which an annuity payment period is permitted to change, unless Employee X remarries subsequent to the death of his spouse and the new beneficiary is his new spouse. In that event, the regulations provide that an increase in annuity payments is permissible in order to eliminate the survivor benefit upon the death of the previous spouse, and that the annuity period may change in order to add a survivor benefit for a new spouse upon marriage.

However, Treas. Reg. 1.401(a)(9)-6, Q&A-16 provides that a governmental plan will not fail to satisfy §401(a)(9) simply because the annuity payments of "an annuity distribution option provided under the terms of a governmental plan as in effect on April 17, 2002 . . . do not satisfy the requirements A-1 through A-15 of this section, provided the distribution option satisfies section 401(a)(9) on a reasonable and good faith interpretation of the provisions of section 401(a)(9)."

Section 401(a)(9)(A) provides:

A trust shall not constitute a qualified trust under this subsection unless the plan provides that the entire interest of each employee –

- (i) will be distributed to such employee not later than the required beginning date, or
- (ii) will be distributed, beginning not later than the required beginning date, in accordance with regulations, over the life of such employee or over the lives of such employee and a designated beneficiary (or over a period not extending beyond the life expectancy of such employee or the life expectancy of such employee and a designated beneficiary).

Employee X's interest in Plan Z will be distributed, beginning not later than the required beginning date, over the lives of Employee X and a designated beneficiary. There is nothing in the language of the statute to indicate that the designated beneficiary may not change. In addition, this provision of Plan Z is consistent with the spirit of the final regulations under §401(a)(9), which allow for adjustments to the annuity period or amount in various unusual circumstances which render it impossible for the annuity payments and/or period to remain as

originally calculated. Therefore, the provision is a reasonable and good faith interpretation of the provisions of §401(a)(9) and will not cause Plan Z to fail to satisfy §401(a)(9).

It is assumed that the annuity payments to the beneficiary will satisfy the minimum distribution incidental benefit (MDIB) requirements imposed by §401(a)(9)(G) and Treas. Reg. 1.401(a)(9)-2. In addition, it appears that a similar provision inserted into a plan after April 17, 2002, or contained in a plan established subsequent to that date would not be permissible.

**Proposed Response:** The designation of someone other than a spouse as a new beneficiary for joint and survivor annuity purposes, subsequent to the death of the original beneficiary, does not cause the plan to fail to satisfy §401(a)(9) provided the plan terms as in effect on April 17, 2002, provided for such a substitution.

**IRS response:** The situation described in the question is not permitted under the §401(a)(9) rules, but, it would be permitted as long as the provision is considered a good faith interpretation of the required minimum distribution rules in effect on April 17, 2002 eligible for the grandfather provision for good faith interpretations.

## **21. §401(a)(28)(B) – ESOP Diversification**

Must an ESOP permit a former employee (who is not employed by the plan sponsor at the time he or she first completes 10 years of participation and/or attains age 55) to diversify employer securities which have been allocated to an account for the former employee and are not yet distributed from the plan?

**Proposed Response:** No. Section 401(a)(28)(A) specifies that an ESOP must satisfy §401(a)(28)(B) and (C) in order to be a "qualified trust" under §401(a). Section 401(a)(28)(B) provides that a plan must grant each "qualified participant" in the plan a diversification right. The term "qualified participant" is defined in §401(a)(28)(B)(iii) as "any employee who has completed at least 10 years of participation under the plan and has attained age 55." See also Notice 88-56 Q&A-12. Since the former employee is not an employee of the sponsor at the time he or she first "completed at least 10 years of participation under the plan and has attained age 55," he or she can never be a "qualified participant," (assuming no rehire) regardless of age or time of plan participation.

**IRS response:** The IRS disagrees with proposed response. The participant continues to count years of participation when an account for the individual is maintained under the plan even if the individual is a former employee.

## **22. §401(a)(28)(B) – ESOP Diversification**

Must an ESOP permit a former employee (who is not currently employed by the plan sponsor but was employed at the time he or she first completed 10 years of participation and attained age 55) to continue to diversify employer securities which have been allocated to an account for the former employee through the remainder of the diversification period?

**Proposed Response:** Yes. Section 401(a)(28)(A) specifies that an ESOP must satisfy §401(a)(28)(B) and (C) in order to be a "qualified trust" under §401(a). Section 401(a)(28)(B) provides that a plan must grant each "qualified participant" in the plan a diversification right. The term "qualified participant" is defined in §401(a)(28)(B)(iii) as "any employee who has completed at least 10 years of participation under the plan and has attained age 55." Notice 88-56

Q&A-12 indicates that a qualified participant must be eligible to diversify in each plan year during the participant's "qualified election period." The qualified election period consists of the 5 plan year period beginning with the plan year after the plan year in which the participant first becomes a qualified participant. Since the former employee was an employee of the sponsor at the time he or she first "completed at least 10 years of participation under the plan and has attained age 55," he or she was a "qualified participant" and is entitled to diversify during the qualified election period, that is, the entire 5 year period. This is only significant if the qualified participant has diversified less than the maximum allowable in years while employed (since there would be no additional allocations to the qualified participant's account after termination) and in the final year, when the diversification percentage increases to 50%.

**IRS response:** The IRS agrees with proposed response.

### **23. §401(a)(31) – Automatic Rollover Requirements**

Question 13 of IRS Notice 2005-5 provides that the spousal consent requirements do not apply to a cash-out of an accrued benefit greater than \$1,000 but not greater than \$5,000 distributed with participant consent. Is a plan required to offer the participant a qualified joint and survivor annuity (life annuity for a participant who is not married) in addition to the lump sum cash-out?

**Proposed Response:** No. If the present value of the accrued benefit does not exceed the §411(a)(11) cash-out amount, the plan need only provide the participant with the choice of taking an immediate lump sum payment.

**IRS response:** The IRS agrees with proposed response.

### **24. §401(a)(31) – Automatic Rollover Requirements**

If a plan provides for an immediate lump sum with participant consent for amounts greater than \$1,000 but not greater than \$5,000 and the participant does not consent to the lump sum distribution, how and when is the accrued benefit paid?

**Proposed Response:** If the present value of the accrued benefit does not exceed \$5,000, the present value may be distributed in a lump sum when the participant attains the later of age 62 or normal retirement age without requiring an automatic rollover. Pursuant to Question 2 of IRS Notice 2005-5, the distribution is not a mandatory distribution and is not subject to the automatic rollover requirements. If the present value of the accrued benefit exceeds \$5,000, the participant must be offered the qualified joint and survivor annuity (life annuity for a participant who is not married) unless another form of benefit is elected with consent as provided by §417(e).

**IRS response:** The IRS agrees with proposed response, but only if the plan is subject to the QJSA requirements.

### **25. §401(a)(31)(B) and 411(d)(6) – Automatic Rollovers and Plan Amendments**

The guidance from both the IRS and the DOL governing automatic rollovers is written as if plans automatically cash out small accounts. In reality, plans generally adopt a permissive, rather than a mandatory approach to such small accounts. That is, a plan may be drafted to track the statute to specify that consent is required for amounts in excess of \$5,000 or specify that amounts not in

excess of \$5000 may be distributed without the participant's consent. Under such approaches, the plan generally attempts to obtain participant consent for small distributions and in those instances where the participant cannot be located, may retain the account. It may be only in the rare situations where the participant's location can be verified but the participant refuses to consent that the plan actually forces out the distribution.

The approach of the guidance is complicated by the real world problem that plans that wish to retain the \$5000 cash out limit lack sufficient financial institutions as resources to receive the automatic rollover.

If the plan is drafted to provide that accounts not in excess of \$5,000 may be distributed without the participant's consent and, where the participant cannot be located, the plan neither forces out the distribution nor rolls over to an IRA, will the plan fail to satisfy the requirements of §401(a)(31)? Specifically, if the plan's procedures are to send out a letter to terminated participants without an accompanying §402(f) form advising the terminated participant that he/she may request distribution by requesting a distribution package then the plan forwards a distribution package, including a §402(f) to those who request them and holds on to the small accounts (not to exceed \$5000) for those who do not until they can be tracked down if necessary. If the plan is drafted to permit, but not require, distribution of such small amounts without participant consent, will the plan fail to satisfy the provisions of either §401(a)(31)(B) or §411(d)(6)?

**Proposed Response:** With respect to §401(a)(31)(B), if a plan is drafted to permit a cash out of an amount of \$5000 or less, but not require, so that the plan first seeks consent, if the plan on termination of participation sends out a letter (but not a §402(f) notice) advising termines that they may request a distribution and only sends out a §402(f) notice (which according to Notice 2005-5 seems to trigger the automatic rollover provisions), to those participants that respond so that the accounts of those who do not respond are neither cashed out nor rolled over, the plan is in compliance with both Notice 2005-5 and §401(a)(31)(B). While the Notice indicates that the triggering event is the issuance of §402(f) note, the real intent is to change the default distribution from direct distribution to an automatic rollover in the case of a small distribution without consent. As such, the real trigger occurs at the time that a distribution would be made. As such, if the above procedure is followed and a participant eligible to receive a mandatory distribution of up to \$5000 does not respond, the plan does not fail to comply with §401(a)(31)(B) if it makes no distribution at all and continues to retain the account.

With respect to §411(d)(6) compliance, nothing in that section mandates that the plan be drafted to mandate a force out. Moreover, the intent of the change in the law was to change only §401(a)(31) and not to change §411(d)(6). A provision that merely allows a plan to cash out an amount, not in excess of \$5,000 but does not require such a cash out, will not run afoul of §411(d)(6).

**IRS response:** If the plan document requires cash out distributions, the plan must be operated in accordance with its terms. If the plan permits employer discretion regarding which participants receive cash out distributions, such discretion violates the prohibition on employer discretion. If the plan requires the participant to fulfill certain requirements in order to receive the distribution, it is not an involuntary distribution. If the plan provides for mandatory distributions and makes involuntary distributions to all appropriate participants except those that cannot be found, the facts of the question are not clear at what point the employer engages in discretionary authority over which participants receive distributions.

## **26. §401(a)(31)(B) & 411(d)(6) – Automatic Rollovers & Plan Amendments**

Can a defined benefit plan that currently has a \$5,000 small benefit cash-out provision amend that plan to permit (but not require) a terminated participant to take the present value of his or her benefit in a lump sum following termination of employment, without allowing other annuity forms of benefit to be available to that participant at that time? The regulation on automatic rollovers indicates that spousal consent is not necessary in this instance, but it is unclear whether the participant would need to be offered other options at that time (which would be cumbersome) and consent to payment in a form other than an annuity. Also, if this approach is generally permitted, could a plan that allows a participant to elect various optional forms in that instance (where accrued benefit does not exceed \$5,000) be amended to eliminate the options other than lump sum; the regulations give authority to do this where mandatory cash-out is being added, but unsure if those rules would apply here where voluntary cash-out is involved.

**Proposed Response:** The participant need only be offered the choice between the immediate lump sum distribution and a deferred annuity option that includes all the optional forms payable under the plan. If the plan currently offers other optional forms payable on an immediate basis, the plan can be amended to eliminate those distribution options for participants whose benefit has a present value less than \$5,000.

**IRS response:** The IRS agrees with proposed response, if the benefit is \$5,000 or less.

## **27. §401(b) - Determination Letter Requests: Prior Documentation Requirements**

In order to obtain a determination letter upon restatement, an applicant must submit the prior determination letter. If an employer does not have a prior determination letter, the applicant must submit all prior documents.

1. If the employer's last preceding document was drafted on a "Standardized Prototype" or a word-for-word adoption of a Volume Submitter document, does the opinion or advisory letter for that plan constitute a determination letter, and therefore, no prior documents are required?
2. What can an applicant do if, notwithstanding diligent efforts, she is unable to obtain a copy of the opinion or advisory letter from the document sponsor?

### **Proposed Response:**

1. Yes. Rev. Proc. 2004-05 provides that "If an employer can rely on a favorable opinion or advisory letter...the opinion or advisory letter shall be equivalent to a favorable determination letter."
2. The applicant should be permitted to submit the prior document along with the best available evidence that the plan was a Standardized Prototype or word for word adoption of a lead Volume Submitter Document. The applicant should not be forced into the correction program merely because the prior service provider will not cooperate (or failed to include a copy of the IRS letter with the adoption agreement, as required).

### **IRS response:**

1. The IRS agrees with proposed response.
2. The applicant should submit the best available evidence and should not be forced into the EPCRS.

## **28. §401(k) – Cash or Deferred Arrangement: Corrective Distributions and ADP Testing**

Employer has a profit sharing plan with a §401(k) feature. Employer has two highly compensated employees. Both contribute the maximum of \$14,000 in elective deferrals for the 2005 Plan Year. Employer intends to contribute a \$28,000 profit sharing contribution for each HCE, so as not to exceed the §415 limit for 2005 of \$42,000. However, Employer determines that the Plan will fail ADP testing in 2005. Therefore, Employer makes a \$42,000 profit sharing contribution instead. The Plan then refunds \$14,000 in elective deferrals (plus gains attributable to the deferrals) to each of the two HCEs as a correction of a §415 excess. According to Treas. Reg. 1.415-6(b)(6)(iv), the HCEs now have no elective deferrals for the ADP test, and the Plan passes ADP testing. Is this permissible?

**Proposed Response:** Yes, assuming the Plan provides for the distribution of elective deferrals to reduce excess annual additions. The §415 excess was based on a reasonable error in determining the amount of the HCEs' elective deferrals. Employer's profit sharing contribution was within the §415 limits. The HCEs' elective deferrals (which could have ranged from \$0 to \$14,000) caused the HCEs to exceed the §415 limits. Therefore, the elective deferrals (plus gains attributable to the elective deferrals) can be returned to the HCEs.

**IRS response:** The IRS respectfully disagrees with proposed response. The IRS does not believe the fact pattern describes a reasonable error in determining elective deferrals. The IRS noted new §415 regulations would be released shortly and should address the issue of corrective distributions for excess annual additions.

## **29. §401(k) – Cash or Deferred Arrangement: Corrective Forfeitures**

Company X maintains a §401(k) plan for its employees. Assume the following scenarios.

Assume employee A is a commissioned salesperson and sells a product to a customer for which s/he would be entitled to a commission. Customer has 30-day period in which to cancel sale. Assume customer cancels sale. A has had §401(k) and matching contributions allocated to his/her account based on the commission from the sale of the product that was later cancelled by customer. Can the plan forfeit the match and §401(k) contribution based on the cancelled sale? If the §401(k) contributions cannot be forfeited, can future §401(k) contributions be reduced until the over-allocation is eliminated? What happens if the employee terminates employment before future deferrals can be reduced?

Assume Employee B is a commissioned salesperson and sells a product for fraudulent reasons. B earns a commission for which X allocates a §401(k) contributions and matching contribution to B's account under its §401(k) plan. Internal investigation reveals B's fraud. Can the plan forfeit the match and §401(k) contribution based on the fraudulent circumstances of the sale? If the §401(k) contributions cannot be forfeited, can future §401(k) contributions be reduced until the over-allocation is eliminated? What happens if the employee terminates employment before future deferrals can be reduced?

Assume Employee C is a salaried employee and elects to make a §401(k) contribution of 6% of compensation. Due to an administrative error, the plan erroneously credits contribution of 8% of compensation even though only 6% contribution reduced from C's pay. Can the plan forfeit the excess §401(k) contribution? If the §401(k) contributions cannot be forfeited, can future §401(k)

contributions be reduced until the over-allocation is eliminated? What happens if the employee terminates employment before future deferrals can be reduced?

Assume Employee D is a commissioned employee and sells a product to a corporation. D earns a commission for which X allocates a §401(k) and matching contribution to D's account under X's §401(k) plan. An internal investigation later reveals that the circumstances of the sale suggest that the buyer of the product intended to use it for purposes of money laundering. A further investigation reveals that one of the directors of the corporation is an al-Qaeda operative identified by Homeland Security as a major terrorist. Can the plan forfeit D's §401(k) contribution and matching contribution based on the improper sale? If the §401(k) contributions cannot be forfeited, can future 401(k) contributions be reduced until the over-allocation is eliminated? What happens if the employee terminates employment before future deferrals can be reduced?

In each of the above circumstances, is it implied that compensation means that which was properly earned? If an error occurs can the error be corrected by a payroll reversal? Or is a plan amendment necessary to take such corrective action? EPCRS talks about overpayments which are payments in excess of the amount the participant is entitled to. But can a plan take a preemptive approach to prevent overpayments on or after the time when contributions are allocated?

**Proposed Response:** While some of these scenarios may involve mistakes of fact for which applicable contributions may be recovered by the employer without using EPCRS, provided our guidance on this issue is followed, we have, under what is now known as the VCP program, permitted corrections of allocations involving contributions and earnings.

**IRS response:** The IRS was impressed with the creativity of the fact pattern. The IRS believes the contribution for Employee C was a mistake of fact, but that the contributions for employees A and B are not mistakes of fact. Where similar situations could arise, the employer should delay the plan contribution until the commission is completely earned and not subject to reduction.

### **30. §401(k) – Cash or Deferred Arrangement: Safe Harbor Plan Requirements**

Notice 98-52 says that the safe harbor §401(k) notice must describe "the type and amount of compensation that may be deferred under the plan." Does this include the indexed §401(a)(17) limit for the coming year?

**Proposed Response:** The safe harbor 401(k) notice does not need to include the indexed §401(a)(17) limit. For a calendar year plan, the safe harbor notice should go out in September, October or November. The indexed amount for the coming year may not be available at that time.

**IRS response:** The IRS agrees with proposed response. Referencing the current limit and noting that it can increase should be sufficient.

### **31. §401(k) – Cash or Deferred Arrangement: Safe Harbor Plan Requirements**

A safe harbor §401(k) plan provides for a 3% nonelective safe harbor contribution. The contribution is based on W-2 earnings paid during that portion of the plan year during which the participant was eligible to participate in the plan. After terminating employment, a participant received severance pay, accumulated vacation pay and a bonus. Should these amounts be included in compensation for purposes of calculating the 3% nonelective contributions?

**Proposed Response:** No. Under the terms of the plan, these amounts should be excluded because they were paid when the participant was no longer eligible to participate in the plan.

Further, these amounts can never serve as the basis of a safe harbor contribution because the employment relationship ended prior to the payment of these amounts. A §401(k) plan participant can neither make elective deferrals from these amounts, nor receive a §401(k) safe harbor contribution based on these amounts.

**IRS response:** The IRS noted that §415 guidance will be released very shortly and will address this issue.

### **32. §401(k) – Cash or Deferred Arrangement: Change in Testing Methodology**

For a given plan year, what is the deadline for amending a §401(k) plan to change from the "prior year" method of ADP/ACP testing to the "current year" method? Must the plan sponsor execute the amendment to change testing methods by the close of the plan year for which the change in testing method is to be effective, or can the sponsor adopt the amendment with a retroactive effective date by the otherwise required deadline for making corrective distributions for the plan year in question?

**Proposed Response:** Treas. Reg. 1.401(k)-1(e)(7) requires the plan document to specify the testing method used. Treas. Reg. 1.401(k)-2(c) permits a plan to change ADP and ACP testing methods from "prior year testing" to "current year testing," or vice versa under certain conditions. Treas. Reg. 1.401(k)-1(e)(7) requires the plan document to specify the testing method used. Because changing ADP/ACP testing methods for a given plan year is simply another means of correcting ADP/ACP failures, akin to making corrective distributions, a retroactive amendment to change testing methods should be permitted at any time up until the deadline for distributing corrective distributions for the plan year in question so long as the change is otherwise permitted by Treas. Reg. 1.401(k)-2(c). Not allowing such retroactive amendments would interject an unwarranted element of gamesmanship into plan administration and potentially bar highly compensated employees from receiving the maximum percentage deferrals that Congress intended to permit.

**IRS response:** The IRS is considering the issue. It is possible the next revenue procedure on the determination letter program will address this issue.

### **33. §401(k) – Cash or Deferred Arrangement**

May a §401(k) plan that passes ADP/ACP testing by providing safe harbor matching contributions permit participants to receive hardship distributions of their entire account balance (elective deferrals, safe-harbor match and profit sharing contributions) if they otherwise satisfy the requirements for a hardship distribution?

**Proposed Response:** So long as the safe-harbor matching contribution (or other employer contribution) was not a QNEC or a QMAC, it could be available for a hardship distribution. To the extent that Notice 98-52 IV.H provided that "Pursuant to §401(k)(2)(B) and Treas. Reg. 1.401(k)-1(d)(2)(ii), hardship is not a distributable event for contributions other than elective contributions", it is superceded by Treas. Reg. 1.401(k)-1(d)(3)(ii) of the final §401(k) regulations issued December 29, 2004 which allow hardship withdrawals of safe-harbor matching contributions so long as such contributions are neither QNECs or QMACs.

**IRS response:** The IRS disagrees with proposed response. The final regulations are clear that hardship distributions cannot include QNECs or QMACs. Safe harbor matching contributions are QMACs and therefore not eligible for hardship distributions.

#### **34. §401(k) – Cash or Deferred Arrangement: Corrective Distributions**

Corrective distributions are required in a variety of situations including excess deferrals, excess contributions, and excess aggregate contributions in order to maintain the qualification of a defined contribution plan. The corrective distributions must include the income allocable to such excess deferrals, excess contributions, and/or excess aggregate contributions.

If a participant that requires a corrective distribution does not have income allocable to the excess deferrals, excess contributions, and/or excess aggregate contributions – but instead has a experienced an overall loss in earnings for the period to which the excess deferrals, excess contributions, and/or excess aggregate contributions relate to – may the loss be ignored for purposes of calculating the total amount of the corrective distribution?

**Proposed Response:** Yes. Allocable losses attributable to excess deferrals, excess contributions, and/or excess aggregate contributions may be ignored for purposes of calculating the total amount of the corrective distribution that is required to be made.

**IRS response:** The IRS disagrees with proposed response. Income includes both gains and losses.

#### **35. §401(k) – Cash or Deferred Arrangement: One-Time Irrevocable Election**

Employer A, a public school corporation that is a political subdivision of a state, has established Plan G (a qualified plan under §401(a)), Plan H (a §401(k) plan), Plan I (a §403(b) plan with elective deferrals only), and Plan J (a §457(b) plan). Under Plan G, an employee is permitted to make a one-time irrevocable election with respect to the employee’s participation and/or contribution level in that plan. Employee D elected upon employment to participate in Plan G. Upon employment, Employee D also made elections to participate in Plans H, I and J.

Do the elections made by Employee D with respect to Plans H, I and J affect Employee D's ability to make a one-time irrevocable election to participate in Plan G within the meaning of Treas. Reg. § 1.401(k)-1(a)(3)(v)?

The IRS permits qualified plans under §401(a) to include a one-time, irrevocable election by employees without regarding the plan as maintaining a CODA and requiring that the plan satisfy the requirements of §401(k).

A cash or deferred election does not include a one-time irrevocable election made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in §219(g)(5)(A) (whether or not such other plan or arrangement has terminated), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee’s compensation (including no amount of compensation) divided among all other plans or arrangements of the employer (including plans or arrangements not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under such plans. Treas. Reg. 1.401(k)-1(a)(3)(v).

Therefore, under §401(a) and §401(k), a governmental plan (that is not a §401(k) plan) may allow a one-time, irrevocable election no later than initial eligibility to contribute or receive accruals under any plan or arrangement maintained by the employer. A “plan or arrangement” for these

purposes includes any plan or arrangement listed in §219(g)(5)(A), which includes: a qualified plan under §401(a); an annuity plan described in §403(a); an annuity contract described in §403(b); a plan established by the U.S., a state or political subdivision thereof, or an agency or instrumentality of any of these; a simplified employee pension within the meaning of §408(k); or a simple retirement account within the meaning of §408(p).

Plans G, H, I and J all qualify as plans for purposes of Treas. Reg. 1.401(k)-1(a)(3)(v) because all of the plans were established by Employer A, a political subdivision of a state. Therefore, in order for a one-time irrevocable election under any of the plans to avoid being a cash or deferred election for purposes of §401(k), that election must be made no later than the date on which Employee D first becomes eligible to contribute or receive accruals under any of the plans. The elections made under Plans H, I and J are not one-time irrevocable elections and, therefore, do not affect Employee D's ability to make a one-time irrevocable election.

**Proposed Response:** Employee D's elections with respect to each of Plans H, I and J do not affect Employee D's ability to make a one-time irrevocable election to participate in Plan D such that the election to participate does not constitute a cash or deferred election, provided the election is made no later than the date on which Employee D first becomes eligible to contribute or receive accruals under Plan D.

**IRS response:** The IRS agrees with proposed response. The number of different elections for different plans does not change the rule concerning a one-time irrevocable election offered upon commencement of employment.

### **36. §401(k) – Cash or Deferred Arrangement: One-Time Irrevocable Election**

Employer B, a state, has established Plan K, a defined benefit plan which is qualified under §401(a), for its employees. Upon employment, each employee become eligible to receive accruals under Plan K and has the opportunity to make a one-time, irrevocable election to join Plan K. Employee E elected to participate upon employment. Three years later, Employer B amends Plan K to provide for a second one-time, irrevocable election available to employees after ten years of service. This election would allow an employee to opt into a new tier providing for a higher multiplier and higher employee contributions. After ten years of employment with Employer B, Employee E elects into the new tier.

Does the election made by Employee E after ten years of service qualify as a one-time irrevocable election within the meaning of Treas. Reg. 1.401(k)-1(A)(3)(v) or is it a cash or deferred election?

Treas. Reg. 1.401(k)-1(a)(3)(v) provides that certain one-time elections are not treated as cash or deferred elections for purposes of §401(k). In particular, the regulation provides that:

A one-time irrevocable election made no later than the employee's first becoming eligible under the plan or any other plan or arrangement of the employer that is described in section 219(g)(5)(A) (whether or not such other plan or arrangement has terminated), to have contributions equal to a specified amount or percentage of the employee's compensation (including no amount of compensation) made by the employer on the employee's behalf to the plan and a specified amount or percentage of the employee's compensation (including no amount of compensation) divided among all other plans or arrangements of the employer (including plans or arrangements not yet established) for the duration of the employee's employment with the employer, or in the case of a defined benefit plan to receive accruals or other benefits (including no benefits) under the plan.

Section 219(g)(5)(A) includes the following plans: qualified plans under §401(a); annuity plans described in §403(a); annuity contracts described in §403(b); any plan established for its employees by the United States, a state, a political subdivision of a state, or an agency or instrumentality of any of these; a simplified employee pension described in §408(k); or a simple retirement account described in §408(p).

Plan K is a qualified plan under §401(a), as well as a plan established for its employees by a state, and is therefore a plan within the meaning of Treas. Reg. 1.401(k)-1(a)(3)(v). Employee E was eligible to receive accruals under Plan K upon employment and made an election at that time. The second election should be considered an election for a new plan because it has higher employee contributions and higher accruals. Employee E cannot reduce his/her contribution nor reduce accruals. The election available at ten years was not available at employment. Therefore, the election made by Employee E after ten years of service with Employer B was made after Employee E's first becoming eligible under the plan and does not satisfy the exception set forth in Treas. Reg. 1.401(k)-1(a)(3)(v).

**Proposed Response:** The election upon ten years of service will not be a cash or deferred election, and Plan K will not therefore include a cash or deferred arrangement within the meaning of §401(k).

**IRS response:** The IRS disagrees with proposed response. There is no second chance to make a one-time election.

### **37. §401(k) – Cash or Deferred Arrangement: Distributable Events**

The preamble to the final 401(k) regulations published on December 29, 2004 explained that, after reviewing comments requested by the IRS on whether a change in status from a common law employee to a leased employee described in §414(n) would be treated a severance from employment that would permit a distribution of a §401(k) account, the IRS decided not to add the change to leased employee to the list of distributable events. What constitutes a bona fide severance from employment in the case of a participant who separates from service, and after some period of time, performs services for the employer as a leased employee?

**Proposed Response:** An employee who separates from service without any prearrangement to provide further services to the employer, and who in fact provides no further services to the employer after such separation from service for a minimum of 30 calendar days, should be deemed to have a bona fide severance from employment, regardless of whether such former employee provides additional services to the employer as a leased employee or otherwise after a minimum of 30 days have passed after the separation from service. The plan should be permitted to conclusively rely on representations of the employer regarding the lack of a prearrangement.

**IRS response:** The IRS was not willing to bless a 30 day rule since they did not believe this situation should have a bright line rule, nor to allow the plan to conclusively rely on the employer's representations regarding whether the re-employment is the subject of any pre-arranged agreement. The IRS generally expressed skepticism regarding rehires of retired employees after a short period of time, but did not opine on what periods would be considered too short.

### **38. §401(m) – Matching Contributions: Application of Pay Limit**

The Service has previously indicated that the compensation limit is applied on an annual basis and that a plan is not required to cut off a participant's elective deferrals when his or her annual compensation reaches the limit. Does the same rule hold true for matching contributions on those deferrals? For example, a plan provides matching contributions of 100% on the first 4% of elective deferrals (capped at 4% of the compensation limit - \$8,400 for 2005). A participant earning \$420,000 for the year elects to defer 3% of each pay. If the plan follows the above-referenced rule for §401(k) contributions, the participant would defer \$12,600 for the year. If the plan cuts off the match after compensation reaches the compensation limit (halfway through the year), the match would be limited to \$6,300. Otherwise, the match would cut off at \$8,400.

**Proposed Response:** The same rule applies for matching contributions as for elective deferrals. The compensation limit is an annual limit that does not require termination of matching contributions that would otherwise be made in connection with a participant's elected level of deferral, so long as the annual match is capped as described.

**IRS response:** This is a question concerning how to draft the plan. The plan does not have to apply the §401(a)(17) limit to the first dollars earned by a participant.

### **39. §402 – Basis in S Corporation Stock Held by ESOP**

Revenue Ruling 2003-27 implies that undistributed S corporation income should be reported on the Form 5500. However, there appears to be no place on Form 5500 or the related schedules to report this income, and many small plans are not even required to file Schedule H (Financial Information), which is the only schedule on which this type of information may be reported. Must undistributed S corporation income be reported on Form 5500? If not, is basis adjustment still required?

**Proposed Response:** It appears that reporting such amounts, which are not plan assets and do not flow through the plan, is inappropriate, but basis adjustment is required.

**IRS response:** The plan has to report income and adjust the basis. The Form 5500 should be revised to make this clearer, and the IRS will work on this, but it is likely that will not occur until the 2007 Form 5500. Until a revision occurs, this information should be reported on Schedule H or Schedule I, depending on the size of the plan, and adjust the basis accordingly.

### **40. §402 – Basis in S Corporation Stock Held by ESOP**

According to Rev. Rul. 2003-27, the basis of S corporation stock owned by an ESOP is increased by undistributed S corporation earnings (i.e., the AAA account).

a. Will distribution of an amount equal to that account balance by the S corporation to its shareholders, including its ESOP, reduce stock basis back down to its original cost basis, thus restoring full net unrealized appreciation ("NUA") long-term capital gain entitlement to ESOP participants who receive that stock as part of a lump sum distribution from the ESOP?

b. Would there be a problem if an S corporation desired to restore the full NUA potential of the ESOP participants by distributing its AAA account?

**Proposed Response:** This should be nothing more than an administrative calculation that, under the rationale of Rev. Rul. 2003-27, is used to calculate ordinary income and NUA on the distribution of stock by an S corporation ESOP.

**IRS response:** Distributions of cash do reduce stock basis, but only if all shareholders receive a distribution, not just ESOP shareholders. A S corp should not have a disproportionate distribution of cash among shareholders.

#### **41. §404 – Deductible Limit: Current Liability Interest Rates for Minimum and Maximum Purposes**

For 2004 and 2005 plan years, the Pension Funding Equity Act (“PFEA”) requires the use of 90% to 100% of the corporate bond rate for calculating current liability for minimum-funding purposes. For purposes of calculating the maximum-deductible contribution, § 404(a)(1)(F) — as added by PFEA — states that “an employer may elect to disregard” the new provisions providing for the use of the corporate bond rate.

For 2004 and/or 2005 plan years, may an employer calculate the minimum-required contribution using 100% of the corporate bond rate, and simultaneously calculate the maximum-deductible contribution using 90% of the 30-year Treasury rate?

**Proposed Response:** Yes, the ability to calculate the 2004 (or 2005) maximum-deductible contribution using 90% of the 30-year Treasury rate is not dependent upon the rate used for 2004 (or 2005) minimum funding purposes.

**IRS response:** The IRS agrees with proposed response. For the 2004 and 2005 plan years there is a specific disconnect between the funding and deductible limit interest rates.

#### **42. §404 – Deductible Limit: Determining Compensation for Combined Limit on Deductible Contributions**

An employer sponsors a defined benefit plan and a profit sharing plan that cover a common group of participants. In addition to the employees covered by both plans, some employees participate only in the defined benefit plan and other employees participate only in the profit sharing plan.

1. An active employee covered only by the DB plan has an accrued benefit at the beginning of the year, but accrues no additional benefit during the year. Is compensation for this employee considered for purposes of determining the 25% of compensation limit under §404(a)(7)?
2. An active employee covered only by the profit sharing plan has an account balance at the beginning of the year, but receives no allocation during the year. Is compensation for this employee considered for purposes of determining the 25% of compensation limit under §404(a)(7)?

**Proposed Response:**

1. Yes. This individual is still considered to be a beneficiary under the plan for purposes of §404(a)(7).
2. No. Per Rev. Rul. 65-295, only compensation of individuals who receive an allocation of the employer’s contribution in the year for which such contribution is made is considered.

**IRS response:** The IRS will consider this as a suggestion for guidance on a future Guidance Priority List.

#### **43. §404(k) – Deduction for Dividends Paid on Employer Securities**

How does one determine whether an "applicable dividend" paid by a closely-held corporation should be disallowed as constituting "an evasion of taxation?" Under what circumstances would such a dividend that otherwise qualifies under §404(k) be deemed to be other than "reasonable?"

**Proposed Response:** According to the legislative history of TRA '86 (S. Rept. page 1034, TRA-86 Conf. Rept. II 852; and Technical Corrections Blue Book, page 158) the reasonableness of a dividend should be based on whether such a dividend, together with any other compensation paid to the recipient, would violate the "reasonable compensation test." Such a test would be extremely difficult to apply since dividends are paid pro rata based upon stockholdings, while reasonable compensation is determined on an individual recipient basis. The IRS has ruled in PLR 9304003 that "reasonable" dividends should be determined by what a corporation can be expected to pay on a recurring basis. There is, however, an extensive body of law which focuses on the corollary of this question as it applies to the accumulated earnings tax. Under §531, this tax applies to corporations that fail to distribute earnings not needed in the business as dividends to their stockholders. Would it not be appropriate to apply the rules that are used to determine whether the retention of earned income is justified to determine the analogous question whether a dividend paid by an ESOP company is "reasonable" under §404(k)?

A closely-held company has a convertible preferred stock that pays a seven percent dividend. This dividend is used to make payments on the ESOP's stock acquisition indebtedness, and is not used for the dividend reinvestment under §404(k)(2)(A)(iii). The company has sufficient cash flow to pay this dividend on a recurring basis. No similar publicly traded company pays common dividends in excess of four percent. How is the reasonableness of this dividend determined for purposes of the "avoidance or evasion" disallowance authority under §404(k)? Does the Conference Committee publicly traded common stock standard apply only to the deductions for dividend reinvestments under new §404(k)(2)(A)(iii)? Does the "payable on a recurring basis" standard continue to apply for dividends used to make loan payments or that are passed through in cash to participants without a reinvestment option?

The conference committee report provisions on reasonableness of dividends appear to apply only to dividends deducted under §404(k)(2)(A)(iii), and not to dividends deducted under other parts of §404(k).

**IRS response:** The IRS agrees with proposed response. This is a facts and circumstances test for which the IRS does not have published guidance. In the absence of guidance, the reasonableness standard described above would apply to dividends used to pay loan repayments and paid to participants.

#### **44. §404(k) – Deduction for Dividends Paid on Employer Securities**

A company takes a deduction for paying a seven percent dividend to the ESOP that participants have the choice of either reinvesting in company stock or being paid in cash under new §404(k)(2)(A)(iii). Later, it is determined that the maximum reasonable rate would have been four percent. Is the entire seven percent deduction lost, or only the three percent excess amount?

**Proposed Response:** The literal language would appear to deny the deduction for the entire dividend, but this seems draconian unless the overage can be recharacterized as a contribution and fit within the limits of §404 and §415.

**IRS response:** The IRS disagrees with proposed response. If an unreasonable dividend is paid, the entire deduction is disallowed, not just the excess.

#### **45. §404(k) – Deduction for Dividends Paid on Employer Securities**

A participant elects to have dividends paid on shares allocated to his account reinvested in company stock, pursuant to §404(k)(2)(A)(iii)(II). One week later, he elects to have the acquired company stock sold, with the proceeds reinvested in other investments. Does the reinvestment of the company stock adversely affect the company's right to a dividend deduction?

**Proposed Response:** Nothing in the statute implies that the time period for which the employee's account holds the shares makes any difference.

**IRS response:** The IRS agrees with proposed response. There is no minimum time the participant must hold the employer stock in order to satisfy the dividend deduction rule. If the plan allows participants to change the investment of the account, such sale of the employer stock does not affect the deductibility of the dividend.

#### **46. §409(e) – ESOP Voting Rights**

If an ESOP company fails to “pass through” the vote to participants, what is the correction? Does this answer change if the ESOP’s ownership percentage is not sufficient to change the outcome of the vote?

**Proposed Response:** A new participant vote should be taken to ratify or reject the outcome of the prior vote, unless it can be demonstrated that this vote would not alter the outcome, no further action should be required.

**IRS response:** The IRS considers the failure to pass through the voting rights to participants to be a very serious violation, and while the plan can come into the EPCRS, the failure possibly triggers fiduciary issues under Title I of ERISA.

#### **47. §409(l) – Definition of Employer Securities**

Approximately ten percent of an ESOP company's workforce consists of leased employees, who are on the payroll of a leasing organization, but who work on a full-time basis for the ESOP company under its direction and control. May these employees be included as participants in the ESOP, and receive allocations of ESOP company stock? Or would that violate the “employer securities” provisions of §409(l) with respect to these employees?

**Proposed Response:** Although the statutory language can be read to exclude these employees, it is not consistent with the general purpose of Congress in permitting and encouraging ESOPs. The situation would be exacerbated if their exclusion were to cause a section 410 coverage failure.

**IRS response:** The IRS noted that under the current statutory definition of leased employee, very few workers would be considered leased employees, but that if a worker is a leased employee, they should not participate in the plan.

#### **48. §409(p) – S Corporations & ESOPs**

For purposes of §409(p) testing, assume (a) that a company has 100 shares of stock outstanding, all of which are held by the ESOP, (b) that eleven persons have options to acquire ten shares each, and (c) that these eleven individuals have no other stock ownership (outright or "deemed") or "synthetic equity".

- i. Are any of the eleven individuals "disqualified persons?"
- ii. Is the year a non-allocation year?

**Proposed Response:** Section 409(p)(5) reads in part as follows: "[S]hares of stock in such corporation on which such synthetic equity is based shall be treated as outstanding stock in such corporation and deemed-owned shares of such person if such treatment of synthetic equity of 1 or more such persons results in (A) the treatment of any persons as a disqualified person, or (B) the treatment of any year as a non-allocation year." Accordingly, synthetic equity owned by a person who owns less than 10 percent of the stock (including synthetic equity) would not be a disqualified person, and if disqualified persons do not own 50 percent or more of the outstanding stock, there will not be a nonallocation year.

**IRS response:** The IRS believes the proposed response is technically correct, since each person has an option for 10 shares and so for each person the ownership percentage would be 10 shares out of a total of 110, they are not disqualified person. But the situation raises a serious question of ESOP dilution and the IRS would look closely at such a transaction to see if it were created to avoid the requirements of §409(p).

#### 49. §409(p) – S Corporations & ESOPs

Does "synthetic equity" include rights to acquire existing outstanding stock under buy-sell agreements or under wills?

- a. An ESOP, Henry, and Barbara each own one-third of a company. Henry and Barbara have a shareholder's agreement giving each the right to purchase shares from the other at fair market value upon the other's death. Does this shareholders' agreement create synthetic equity with regard to two-thirds of the company's stock?
- b. David owns 60 percent of a company and an ESOP owns 40 percent. David has a will, leaving all of his stock to his wife upon his death. Does his wife have synthetic equity of 60 percent of the company?

**Proposed Response:** There is no abuse where the right is to acquire existing shares rather than newly-issued shares, and the reference in §409(p)(6)(C) to rights "similar" to stock options, warrants, restricted stock, and deferred issuance stock rights should be interpreted as rights to acquire newly-issued shares.

**IRS response:** This is addressed in the regulations, because a buy-sell agreement doesn't potentially dilute ESOP ownership. But if the person with rights under the buy-sell agreement otherwise is a disqualified person, the shares controlled by the buy-sell agreement could count for purposes of the 50% test.

#### 50. §409(p) – S Corporations & ESOPs

A plan document includes the §409(p) prohibited allocation rules, but a prohibited allocation occurs anyway. Is the plan disqualified?

**Proposed Response:** The conference committee report says no, but that would appear to be contrary to other IRS policy.

**IRS response:** The IRS disagrees with the interpretation of the conference report, which says the excise tax applies. The conference report indicates the plan is not disqualified if it is subject to the excise tax, which can be triggered by holding synthetic equity which is not a disqualifying event. But if a plan is operated not in accordance with the terms of the document, that is a disqualifying defect.

### **51. §409A – Nonqualified Deferred Compensation: Payment of Exercise Price with Previously Owned Stock**

Does the use of already-owned stock to pay for the exercise price of a stock option (incentive or nonstatutory) constitute a "feature for the deferral of compensation other than the deferral of recognition of income until the later of exercise or disposition of the option under § 1.83-7" as contemplated in Q&A 4(d)(ii) of Notice 2005-1?

**Proposed Response:** No. Despite the fact that the option holder does not report all gain on the stock used to pay the exercise price at the date of the transaction, this feature does make a stock option "deferred compensation" subject to §409A because the unrecognized gain is not compensation.

The deferral of gain on the previously owned stock is demonstrated in the following example, which is based on Rev. Rul. 80-244:

In Year 1, S, an employee of X Corp, acquired 600 shares of X Corp's stock with a basis of \$20 each (i.e., a total basis of \$12,000). In Year 3, X Corp gave S a non-statutory option to buy 1,000 shares at the option price of \$30 a share. The option didn't have a readily ascertainable fair market value at grant, so the grant of the option was not taxable at that time. In Year 4, the market price of the stock had risen to \$50 a share, and S decided to exercise the option. S paid X Corp \$30,000 (\$30 option price × 1,000 shares) to exercise the option. Under the terms of the option, S could have paid the option price for the 1,000 option shares by giving X Corp 600 of S's old shares (600 shares × \$50 a share). By giving up 600 old shares to acquire 1,000 new shares, S defers an \$18,000 gain on the old shares (\$30,000 market value – \$12,000 basis). But the \$20,000 spread between option price and value (\$50,000 minus \$30,000) is compensation income to S (400 shares times \$50 per share) when S exercises the option, regardless of how S "pays" the option price.

The rules in §1036, which allow stock in a corporation to be exchanged for the same type of stock in the same corporation without the recognition of gain or loss, should not be affected by §409A. In fact, Notice 2005-1 states that "[t]ax payers should note that although the statute makes a number of fundamental changes, section 409A does not alter or affect the application of any other provision of the Code or common law tax doctrine."

**IRS response:** The use of previously acquired stock to pay the exercise price of nonstatutory stock option does not constitute a feature for the deferral of compensation if the transaction does not otherwise result in the omission of compensation that would arise upon the exercise.

### **52. §409A – Nonqualified Deferred Compensation: Vesting**

Since plans that pay benefits immediately upon vesting are exempt from the new deferred compensation rules, if a plan contains a provision vesting participants upon retirement (defined as termination after attainment of certain age and service criteria), is the participant vested upon meeting the age and service criteria (subjecting the plan to the new rules) or on termination (exempting the plan from the new rules)?

**Proposed Response:** The participant is only vested upon both meeting the criteria and terminating employment.

**IRS response:** The IRS disagrees with proposed response. Since everyone terminates employment eventually, termination of employment is not an event that can give rise to a substantial risk of forfeiture.

### **53. §410 – Waiver of Participation**

Assume a partnership maintains a cash balance plan. Can the plan provide that a partner may elect to waive participation in the plan?

**Proposed Response:** A partner or owner of an LLC taxed as a partnership may not waive participation in a cash balance plan. A waiver would result in increased “take-home pay” for the partner, which is impermissible in a plan that does not comply with the cash and deferred requirements under §401(k).

**IRS response:** It depends on the terms of the partnership agreement. If the waiver causes the partners distributable share to change accordingly, then the waiver is a cash or deferred election. The IRS noted the same theoretical issue exists in a sole proprietor situation, where the decision to sponsor a plan has the same effect, but the IRS is only concerned with the issue in a partnership setting.

### **54. §410 – Minimum Coverage: Age & Service Conditions**

Do the break in service rules under §410 apply in the same way in determining eligibility for different types of contributions as they do in determining eligibility under the plan as a whole? To take an extreme case, an employee with a vested benefit who quits and comes back to work generally must be allowed back into the plan as soon as he returns, but is the same true for each type of contribution under the plan? Assume that the plan is a profit sharing plan that provides employee elective, employer matching, and employer nonelective contributions. Could the employee be treated the same as a new employee with respect to employer matching or nonelective contributions but not employee elective contributions, for example?

**Proposed Response:** The break in service rules under §410 apply in determining eligibility for the plan as a whole and not in determining eligibility for different types of contributions. Differences in eligibility might cause other problems, e.g., discrimination, but generally not violations of §410.

**IRS response:** The IRS agrees with proposed response.

### **55. §410(b) – Minimum Coverage Testing: Puerto Rican Employees**

Are there any testing alternatives available to enable an employer to pass coverage testing on a US-qualified §401(k) plan, where the employer establishes a Puerto Rican-qualified §401(k) plan for its large Puerto Rican nonhighly compensated employee group, and maintains a US-qualified §401(k) plan for its US employees?

**Proposed Response:** Unfortunately, while establishing the Puerto Rican-qualified §401(k) plan is the only way to provide the Puerto Rican employees with §401(k) benefits on a tax-deferred basis, there is no exclusion under the US tax code for Puerto Rican employees, and their compensation must be included in testing under all of the safe harbors. Under the circumstances, however, an individual determination for a QSLOB would have a good chance for success.

**IRS response:** The IRS unfortunately agrees with proposed response. No opinion was expressed on the possibility of obtaining QSLOB status.

#### **56. §411 & §417 – Participant and Spousal Consent: Applicable Distributions**

A defined benefit plan provides for a partial cash-out up to \$10,000 optional form of payment. A participant terminates and elects to receive \$10,000 (with spousal consent) with the residual annuity payable at his normal retirement age. The plan also provides for a mandatory cash-out of benefits with value under \$5,000. When the value of the participant's residual benefit is measured during 2005, it is below the threshold of \$5,000. Is the participant's residual benefit in such situation subject to a mandatory cash-out?

**Proposed Response:** Final cash-out regulations have eliminated the "look back" rule, therefore, only the present value of the remaining benefit should be compared with the \$5,000 threshold. Therefore, the plan has to distribute the value of the residual benefit as soon as practically possible. In addition, since the original partial distribution had required a spousal consent, the consent of the spouse is not required if the value of remaining benefit is under \$5,000.

**IRS response:** It depends on the terms of the plan document. If the prior distribution occurred in the same year, and the plan determined the amount for a cash-out distribution by looking at prior distributions in the same year, then the cash-out distribution should not be paid. But the prior distribution may not need to be taken into account if it occurred in earlier years.

#### **57. §411(a) – Accrued Benefit and Normal Retirement Age**

Under the plan's formula, a participant accrues a percentage of final average pay per year of service, with the accrued benefit payable in full at the participant's Social Security retirement age (i.e., 65 – 67, depending on the participant's year of birth). The plan defines age 65 as the normal retirement age. Participants fully vest at the normal retirement age and benefits are payable to terminated employees at the normal retirement age. May the plan provide that the amount payable at the normal retirement age is the accrued benefit (i.e., the benefit payable at the participant's Social Security retirement age) actuarially reduced for the age difference between the normal retirement age and the participant's Social Security retirement age?

**Proposed Response:** Yes. The plan's accrued benefit satisfies the definition in Treas. Reg. 1.411(a)-7(a)(1)(ii). The plan has an acceptable normal retirement age (see Treas. Reg. 1.411(a)-7(b)) and provides the various rights required in conjunction with the normal retirement age (e.g., full vesting, immediate distribution right to terminated employees). There is no requirement that the benefit payable at the normal retirement age not be actuarially reduced from the amount defined under the plan's accrual formula.

**IRS response:** The IRS agrees with proposed response, but noted the plan document would have to be carefully drafted. Accrued benefits at normal retirement age can reflect the reduction but the plan should be drafted carefully in order to avoid creating new benefits.

**58. §411(d)(6) - Anti-cutback Rule: Change in QPSA Benefit**

Can a defined benefit subject to §411 be amended to reduce the amount of a qualified preretirement death benefit?

**Proposed Response:** Yes, so long as (i) the participant is living at the later of the time the amendment is made or the effective date of the amendment and (ii) a qualified domestic relations order providing otherwise is not in existence at the later of the time the amendment is made or the effective date of the amendment. Death benefit coverage is not covered by the anti-cutback rule.

**IRS response:** The IRS agrees with proposed response. The death benefit described is not covered by the anti-cutback rule.

**59. §411(d)(6) – Anti-Cutback Rule: Transferee Plan**

Section 411(d)(6)(B)(ii) prohibits the elimination of an optional form of benefit. Section 411(d)(6)(D)(i) permits a transferee plan to not provide some or all of the forms of distribution offered by a transferor plan. Does the reference in §411(d)(6)(D)(i) to forms of distribution, rather than optional forms of benefit, indicate that a transferee plan within the meaning of §411(d)(6)(D) is required to protect optional forms of benefit (such as an age 59 1/2 in-service withdrawal provision), but can eliminate non-single sum forms of distribution (such as installments)?

**Proposed Response:** No. Section 411(d)(6)(D) permits a transferee plan to eliminate all optional forms of benefit, except a single sum distribution. Accordingly, for purposes of §411(d)(6), the reference in Section 411(d)(6)(D) to a form of distribution is synonymous to the reference in §411(d)(6)(B)(ii) to an optional form of benefit.

**IRS response:** The IRS agrees with proposed response. The transferee plan can eliminate all optional forms of benefit other than the single sum distribution.

**60. §414(a) – Service for Predecessor Employer**

Section 414(a)(1) provides that, if an employer maintains a plan of a predecessor employer, service for that predecessor is treated as service for the employer. Assume that Company A and Company B each sponsor a profit sharing plan. Company A and Company B merge to form Newco, which continues to maintain the Company A plan for the benefit of former Company A employees, and the Company B plan for the benefit of former Company B employees. Some employees in the Newco/Company A plan also have pre-merger service with Company B. For purposes of vesting in the Newco/Company A plan, is Newco required to count pre-merger Company B service as well as Company A service?

**Proposed Response:** No. Treas. Reg. 1.411(a)-5(b)(3)(iv)(A) states that "service with a predecessor employer who maintained the plan of the current employer is treated as service with

such current employer." Because Company B did not maintain the Company A plan, service with Company B is not treated as service with Newco with respect to the Newco/Company A plan.

**IRS response:** The IRS agrees with proposed response.

#### **61. §414(c) – Controlled Group of Businesses Under Common Control**

Proposed Treas. Reg. 1.414(c)-5 applies controlled group rules to exempt organizations and organizations which are not exempt. Will there be any "transition" period before these rules apply, in light of the ambiguity in this area prior to this regulation?

**Proposed Response:** There will be a transition rule for qualified plans maintained by organizations which are not exempt and now become part of a controlled group with exempt organizations under Proposed Treas. Reg. 1.414(c)-5. With respect to a qualified plan maintained by a non-exempt organization under these circumstances, we suggest that such organization will have until the end of the second plan year following the date that final regulations are effective to either (1) freeze, (2) terminate or (3) amend such plan.

**IRS response:** The IRS indicated it would treat this question as a comment on the proposed regulations.

#### **62. §414(l) – Transfer of Plan Assets: Spin-off of Plan with 401(h) Account**

Plan A has assets in a §401(h) account to provide for retiree medical benefits for non-key employees. Plan B is being spun off from plan A.

- a) Should a portion of the Plan A's §401(h) assets be transferred to a §401(h) account in Plan B?
- b) If the answer to a) is yes, how should the spin-off amount be determined?
- c) How is Plan A's subordination limit allocated between the two plans after the spin-off?

**Proposed Response:**

- a) Yes.
- b) The asset allocation should be reasonable. In particular, §401(h) assets allocated to either plan should not exceed the present value of retiree medical benefits expected to be paid to participants allocated to that plan.
- c) The subordination limit should be allocated on a reasonable basis.

**IRS response:** The IRS agrees with proposed response.

#### **63. §414(s) – Compensation**

Is compensation of Puerto Rican citizens (who are likewise U.S. citizens) working and residing in Puerto Rico treated as compensation under all of the safe harbors available under §414(s) and §415(c), and the underlying regulations?

**Proposed Response:** Yes.

**IRS response:** The IRS agrees with proposed response.

**64. §414(u) – Veterans Reemployment Rights: Restored Elective Deferrals**

Under USERRA, returning military personnel are given a right to restore §401(k) contributions based on the length of their leave. However, the regulations do not appear to limit the make up contributions to only missed pay periods, but to the §402(g) limits for the coverage period. When an employer pays 100% of regular salary during all or a portion of an employee's leave and the employer has taken out §401(k) contributions based on a pre-service election, can a returning employee allocate make up elections to that coverage year if they did not reach the §402(g) limit?

For example, an employee is called to duty on 7/1/2002. His annual salary is \$50,000 and he is deferring 10%. The employer pays 100% of the participant's normal salary from 7/1/2002 to 06/30/2003. Then the employee is placed on leave of absence and suppressed from payroll. The employee returns from military duty on 09/01/2004. The length of service leave was 26 months. Restoration period is the maximum - 5 years.

If the employee chooses, can the make up contributions be allocated to 2002 to the extent the §402(g) limit was not reached? His full 10% pre-service election from full year salary (5,000 / \$50,000) was withheld in 2002 but he did not reach the §402(g) limit. Since he was on active service and 2002 is covered under the make-up period, can he elect to allocate additional contributions to 2002?

**Proposed Response:** Yes. A returning military leave employee could elect to allocate deferral contributions to a year on which he was on leave, even if the employer paid him his full salary for that period.

**IRS response:** Reemployment rights, including those concerning make-up elective deferrals, are not changed by receiving differential pay from the employer. If the employee made elective deferrals from the differential pay while in active duty, those amounts would obviously not be eligible for make-up deferrals upon reemployment.

**65. §414(v) – Catch-up Contributions: Universal Availability**

Treas. Reg. 1.414(v)-1(e)(2) allows an employer to offer catch-up contributions in plans covering non-union employees without offering them to plans covering union employees. But what if a union insists on obtaining catch-up contributions in a plan covering only union employees? Must the employer also offer catch-up contributions in its non-union plans?

**Proposed Response:** Yes, there is nothing in the regulations that excludes non-union plans from the universal availability rule if catch-up contributions are offered in a union plan.

**IRS response:** No, the non-union plan does not have to offer catch-up contributions. Only plans that offer catch-up contributions are subject to universal availability, so since the non-union plan does not offer contribution, it is not subject to universal availability.

**66. §414(v) – Catch-up Contributions: Universal Availability**

The catch-up contribution regulations do not address the status of multiemployer (collectively-bargained) plans. If a multiemployer §401(k) plan offers catch-up contributions, does a participating employer have to offer catch-up contributions in its single-employer plans?

**Proposed Response:** No. The employer does not "maintain" the multiemployer plan -- it only contributes to it. Therefore, even if the answer to the previous question is "yes" the employer does not have to offer catch-up contributions in its own plans if its only relationship to a multiemployer plan is that it has an obligation to contribute to the multiemployer plan.

**IRS response:** The rule for bargained plans applies to multiemployer plans.

### **67. §417 – Spousal Benefits to Same Sex Spouse**

While there may be some benefits available to spouses that can be extended to domestic partners such as survivor benefits, it would appear that extending other features to domestic partners could jeopardize a plan's qualified status. For example:

- a) A plan administrator could not honor a DRO of a domestic partner unless that partner was a "dependent" in general because honoring such a DRO would violate the anti-alienation rules.
- b) A plan-imposed domestic consent rule for benefit distributions or loans would violate the anti-alienation rule.
- c) The additional value allowed for a QJSA under the §415 limits could not be provided to a domestic partner.
- d) The age of a domestic partner could not be used to determine the minimum distribution period under the exception for spouses.
- e) Medical costs or tuition needs of a domestic partner could not be considered under the §401(k) hardship withdrawal safe-harbor.
- f) Key Employees and HCEs would be determined without taking into account attribution of stock of a domestic partner.

Many plans current define "spouse" in a way that would not necessarily exclude same gender spouses. For example, "Spouse: The spouse or surviving spouse of the participant..." is the definition in DB and DC LRMs.

- a) May a plan treat a same gender spouse as a spouse for the purposes described above?
- b) If the answer to (a) is no, do plans need to be amended to remove the possibility that a same gender spouse would be considered a spouse under the plan?
- c) If the answer to (b) is yes, would the change in the definition violate the anti-cutback rule?

**Proposed Response:**

- a) No
- b) In some cases amendments will be required, in others plan administrators will be able to exercise their interpretive authority under the terms of the plan.
- c) The answer is unclear at this time. Depending upon the plan administrator's interpretation of the plan, it may be possible that an amendment would be required and that it could violate the anti-cutback rule.

**IRS response:** The IRS agrees with proposed response, but the response could be different if the domestic partner qualifies as a dependent for tax code purposes.

**68. §417 – Relative Value Disclosure: Different Content Approaches for Different Options**

Can a single QJSA explanation for a given participant use different "content" approaches for different options?

Treas. Reg. 1.417(a)(3)-1(b)(2) states, "The QJSA explanation must satisfy either paragraph (c) or paragraph (d) of this section." Paragraph (c) provides for communication of participant-specific information. Paragraph (d)(1) permits communication of simply the existence of the option, for those options that are presently available to the participant but not generally available under the plan. Paragraph (d)(2) permits communication of generally applicable comparative information. Both (d)(1) and (d)(2) require the participant to have the right to request and receive more specific information.

Consider a plan containing a large number of different groups of participants with different benefit structures, as the result of past acquisitions and mergers involving the plan sponsor. A given participant has some options that are generally available to all participants under the plan and some options that are available only to the participant's acquisition sub-group of participants within the plan. Some of the options are frequently elected; some are elected very infrequently.

1. Can the QJSA explanation for such a participant provide:
  - a. Participant-specific information (paragraph (c)) for the generally available options, and
  - b. For the sub-group options, only an indication that they exist and an offer to provide further information upon request (paragraph (d)(1))?
2. Alternatively, can the QJSA explanation for this participant provide:
  - a. Participant-specific information (paragraph (c)) for frequently elected options, and
  - b. Generally applicable comparative information (paragraph (d)(2)) for rarely elected options?
3. Alternatively, can the QJSA explanation for this participant provide:
  - a. Participant-specific information (paragraph (c)) for frequently elected, generally available options,
  - b. Generally applicable comparative information (paragraph (d)(2)) for rarely elected, generally available options, and
  - c. For the sub-group options, only an indication that they exist and an offer to provide further information upon request (paragraph (d)(1))?

**Proposed Response:** All alternative approaches are permitted. Treas. Reg. §1.417(a)(3)-1(d)(1) permits a QJSA explanation to provide specific information for generally available options and an indication of how to obtain such information for other presently available options (Alternative 1 above). Proposed changes to the relative value regulations would clarify that the QJSA explanation for a participant can include participant-specific information for some options and generally applicable comparative information for other options (Alternative 2 above). Alternative 3 above is a combination of Alternatives 1 and 2 and is also permissible.

**IRS response:** The IRS agrees with proposed response.

**69. §417 – Relative Value Disclosure: Use of Different Assumptions for Different Participant Groups**

Can relative value comparisons be based on different assumptions for different groups of participants?

Treas. Reg. 1.417(a)(3)-1(c)(2)(iv)(B) requires a set of assumptions that is uniform with respect to optional forms payable to a participant, but does not seem to require that the assumptions be uniform from one participant to the next.

Consider a plan with two distinct groups of participants. For Group A, the plan uses actuarial equivalence Basis X to determine benefit amounts under optional forms of benefit. For Group B, the plan uses actuarial equivalence Basis Y to determine benefit amounts under optional forms of benefit. The plan does not provide lump sums or any other optional forms subject to §417(e) assumptions.

Can the plan use Basis X assumptions to compute relative value comparisons for Group A while using Basis Y assumptions to compute relative value comparisons for Group B?

**Proposed Response:** Yes, as long as both sets of assumptions are reasonable.

**IRS response:** The IRS agrees with proposed response.

**70. §417 – Relative Value Disclosure: Use of Select and Ultimate Interest Rates**

Do the terms “another reasonable interest rate” and “single set of interest and mortality assumptions” in Treas. Reg. 1.417(a)(3)-1(c)(2)(iv)(A) and (B) encompass select and ultimate rates?

For example, may the reasonable interest rate used to develop the relative value of a lump sum distribution be a combination of 4% pre-normal retirement age and 6% post-NRA interest if that combination is specified under the plan to calculate the lump sum?

**Proposed Response:** Select and ultimate interest and/or mortality rates may be used if they are reasonable.

**IRS response:** The IRS agrees with proposed response.

**71. §417 – Relative Value Disclosure: Use of Assumptions Other than §417(e) Applicable Mortality and Interest**

Under Treas. Reg. 1.417(a)(3)-1(c)(2)(iv)(A), the assumptions that must be used to determine the relative value comparison for benefits subject to §417(e)(3) are the applicable mortality table and the applicable interest rate (or, at the option of the plan, another reasonable rate and reasonable mortality table used under the plan to calculate the amount payable under the optional form of benefit).

Suppose a plan states that a lump sum benefit is the larger of:

- (1) The present value of the deferred annuity commencing at normal retirement age calculated using the plan’s general basis for actuarial equivalence -- the applicable mortality table and 7%, and

- (2) The present value of the deferred annuity commencing at normal retirement age using the applicable mortality table and the applicable interest rate.

In providing the relative value comparison between the lump sum and QJSA, can the plan use the 7% assumption instead of the applicable interest rate?

Under what circumstances can the plan use the option to use another reasonable mortality table and interest rate for comparison purposes (instead of the applicable mortality table and applicable interest rate)?

**Proposed Response:** Where a participant's optional form benefit amount is the greater of two different actuarial equivalence calculations, the answer depends on which of the two calculations actually determines the benefit payable. As a result, the answer can vary by participant.

In the example provided, if the present value using 7% is greater than or equal to the present value using the applicable interest rate, then the 7% interest rate can be used for purposes of the required relative value comparison. If the present value is greater using the applicable interest rate, then the applicable interest rate must be used for the relative value comparison.

**IRS response:** The IRS agrees with proposed response.

#### **72. §417 – Relative Value Disclosure: Error in Disclosure Type Based on Marital Status**

Under the federal Defense of Marriage Act (DOMA) a relative value explanation for a participant with a same gender spouse would need to use the rules for unmarried participants. But an employer would not necessarily know a spouse's gender without asking (e.g., if the spouse has a unisex name). Would providing the wrong type of explanation in cases where a distinction is required (e.g., where an unmarried participant is not eligible for the joint and survivor form) lead to a finding that a QJSA waiver is invalid?

**Proposed Response:** Yes it would. If the explanation for single participants is different from the explanation for married participants, the plan administrator will need to ask all participants in advance for an indication of whether they are married and whether their spouse is of the opposite gender or not.

As an alternative, using the substitution permitted under Treas. Reg. 1.417(a)(3)-1(c)(2)(ii)(B), the QJSA explanation for all participants could provide relative value comparisons of all options to the single life annuity and point out that certain optional forms only apply to participants with opposite sex spouses.

**IRS response:** The IRS agrees with proposed response.

#### **73. §417 - Relative Value Disclosure: Application of Delayed Regulatory Effective Date**

Last year Announcement 2004-58 extended the effective date of the relative value regulations until 2/1/2006 for many (but not all) optional forms. The original effective date of 10/1/2004 was retained with respect to any optional form of benefit that is subject to the requirements of §417(e)(3), if the actuarial present value of the optional form is less than the actuarial present value of the QJSA.

Single sums are subject to §417(e)(3). However, Social Security level income options are also subject to §417(e)(3). Was the intent of Announcement 2004-58 to apply the original effective date to level income options?

**Proposed Response:** Yes. The original effective date of 10/1/2004 applies to level income optional forms of payment.

**IRS response:** The IRS agrees with proposed response.

#### **74. §7805(b) – EPCRS: Correction of Failure to Defer**

When a participant fills out an enrollment form and elects a specific salary deferral percentage and the deferrals were not withheld for the year, how do you correct?

**Proposed Response:** EPCRS does not address this specific situation. However, under EPCRS, in cases where an eligible employee is omitted from participating in the plan (making elective deferrals and receiving employer matching contributions), the correction is to make a QNEC and a QMAC based on the average ADP% and ACP%. We believe it is reasonable to use the same correction method for the issue presented in this question.

**IRS response:** The IRS disagrees with proposed response. If the participant makes an election, the employer must correct to put the participant back to where they would be if the error had never been made.

#### **75. §7805(b) – EPCRS: Correction of Failure to Defer**

A §401(k) plan's document states that forfeitures (from matching contributions) may be used to offset future employer contributions and/or pay plan expenses. The plan incorrectly excludes an eligible employee from participating and the plan sponsor self-corrects by making a QNEC on behalf of the excluded participant along with a matching contribution and an earnings adjustment. Can the forfeitures be used to fund the QNEC and matching contribution? Can the forfeitures be used to fund the earnings adjustment?

**Proposed Response:** Yes. Since the forfeitures can be used to offset future employer contributions and the plan sponsor is making an employer contribution to self-correct, the forfeitures can be used to fund the QNEC, matching contribution and earnings adjustment.

**IRS response:** The IRS agrees with proposed response.

#### **76. §7805(b) – EPCRS: Corrective Distributions**

Company X is the employer/plan sponsor of a §401(k) Plan (Plan). Company X provides inaccurate payroll data to the Plan's trustee/recordkeeper. Due to the inaccurate information, trustee/recordkeeper erroneously terminates Participant Y from the Plan and Participant Y's Plan balance is distributed to her, minus a withholding amount of \$420.45 which is forwarded to IRS. Participant Y eventually returns the uncashed distribution check and trustee/recordkeeper re-establishes a plan account for Participant Y with that amount. IRS will not return the withholding amount. Participant Y suffers a 10% early withdrawal penalty of \$42.05 (i.e. 10% of the outstanding withholding amount) and lost earnings of approximately \$72.93. What is the appropriate correction?

**Proposed Response:** Under either the SCP or VCP programs, Company X must use Company X assets to make a corrective contribution to Participant Y's account which will place Participant Y in the position she would have been in had the error not occurred. The contribution should be in

the amount of \$420.45 for the withholding amount erroneously forwarded to IRS, plus the \$72.93 for lost earnings for a total corrective contribution of \$493.38. The penalty amount suffered by Participant Y should not be contributed to Participant Y's Plan account, but rather paid to Participant Y through regular payroll channels as a non-taxable reimbursement.

**IRS response:** The IRS agrees with proposed response, but notes the last sentence of the proposed response is a comment and not a rule. The EPCRS generally does not deal with the taxation of corrective distributions.