AMERICAN BAR ASSOCIATION

JOINT COMMITTEE ON

EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

MAY 13, 1994
1. **Determination Letter Requests**

If a plan is amended to reflect the final regulations (without relying on a reasonable, good faith interpretation) retroactive to 1989, how can the employer tell whether an IRS letter covers the period prior to 1994?

**Proposed Answer:** The employer cannot tell because the submission does not ask whether the plan is intended to reflect the final regulations retroactive to the first plan year after 1988 and the determination letter issued is the same as for a plan that relies on good faith for periods before 1994. However, if the plan's provisions and operations for 1994 are the same as for the 1989-1993 period, approval of the plan for the 1994 plan year, in effect, covers the pre-1994 provisions.

**IRS Response:** The IRS agrees with the proposed answer.

2. **§72(p) - Plan Loan Requirements**

Can the repayment period for participant loans extend beyond normal retirement age without the loan being treated as a taxable distribution, as long as the period does not exceed 5 years?

**Proposed Answer:** The mere fact that the loan repayment schedule extends beyond normal retirement age should not cause a loan to be taxable at the outset. Note that taking the opposite position would appear to be a form of age discrimination.

**IRS Response:** The IRS agrees with the proposed answer. Section 72(p) does not contain a requirement that the loan be repaid by normal retirement age.

3. **§72(p) - Plan Loans**

Due to an inadverintness or scrivener error, some promissory notes have been prepared with a maturity date that is longer than 5 years from the dated date. If a promissory note is dated May 1, 1993, but a maturity date of May 20, 1998, will you deem the note as taxable upon issuance? To correct the error, could the participant be requested to make an early (last) payment prior to May 1, 1998 to prevent the 5 year violation?

**Proposed Answer:** Provided the loan payments do not exceed 5 years in actuality, there would be no §72(p) violation that would cause an individual to be taxed on the note based on the facts provided.

**IRS Response:** The IRS does not agree with the proposed answer. Section 72(p) has to be followed in both form and operation. While there exist several issues about when a plan loan can go bad in operation which the IRS has not addressed, a plan
loan which is bad in form will be treated as a distribution under section 72(p).

4. §219 - ACTIVE PARTICIPANT STATUS
Does an individual become an active participant in a plan (for purposes of determining the deductibility of his IRA contributions) simply by making a rollover contribution to a plan?

PROPOSED ANSWER. No. The individual was an active participant with respect to the year(s) in which the amounts were contributed, but should not be considered to be an active participant solely because those amounts are transferred to another plan.

IRS RESPONSE: The IRS agrees with the proposed answer. A rollover is not a voluntary or mandatory employee contribution, which would make the individual an active participant.

5. §401(a)(4) - NONDISCRIMINATION REQUIREMENTS
A plan credits vesting service for employees who transfer to (or from) a section 414(b) affiliate. Is this post-participation (or pre-participation) service for purposes of Treas. Reg. 1.401(a)(4)-11(d)(3)(i)? Additionally, does the answer change if the service is for early retirement eligibility or final pay upticks?

PROPOSED ANSWER: The service crediting rules in the nondiscrimination regulations apply to service with another "employer" (or service other than as an employee). For this purpose, Code sections 414(b), (c), (m), and (o) apply. Examples 1 through 3 at Treas Reg. 1.401(a)(4)-11(d)(3)(ii)(C)(3) are inconsistent with this and need correction.

IRS RESPONSE: The IRS does not agree with the proposed answer. Service credited for periods before the employee was a participant in the plan is pre-participation service and must meet the nondiscrimination requirements of 1.401(a)(4)-11(d). If vesting service, service may be required under 411, and therefore will be deemed nondiscriminatory. Pre-participation service is based on whether the employee was a participant. No rules governing post-participation service, and imputed service rules do not cover this situation, though service may be required under vesting rules. But no basis for otherwise saying the service is deemed to be nondiscriminatory.

6. §401(a)(4) - NONDISCRIMINATION REQUIREMENT
At one time the Service had expressed concern over window plan benefits whose eligibility was defined by a list of employees' names. Does the Service still have this concern if the plan, including the window, can pass the section 401(a)(4) final rules?

PROPOSED ANSWER. None.
IRS RESPONSE: The IRS interpreted the proposed answer to mean that they did not have the concern any longer, and they agree with this answer. As long as the window plan group satisfies the section 401(a)(4) final rules, there is not a problem. In satisfying the nondiscrimination requirement, the window plan group must satisfy the ratio percentage test, because the nondiscriminatory classification test is unavailable. Naming individuals is not a reasonable classification under the nondiscriminatory classification test.

7. §401(a)(4) - HIGHEST PAID 25 EMPLOYEES  
Treas. Reg. 1.401(a)(4)-5(b)(3)(ii) refers to the highest paid 25 employees and former employees. Is it sufficient for a plan to review records for the prior 6 years (the record retention period under ERISA section 107), assuming records more than 6 years old are not reasonably available and that the plan administrator is not actually aware of any employee who would be in the highest-paid 25 if records were searched more than 6 years into the past?

PROPOSED ANSWER: Rev. Proc. 93-42 allows the use of substantiation quality data which is reasonably available for which the employer reasonably concludes there is a high likelihood that use of such data establishes that the nondiscrimination rules would be satisfied. There is no significant likelihood of discrimination if an unrestricted distribution is made to an employee who is not among the highest-paid 25 employees for the current and preceding 6 years.

IRS RESPONSE: The IRS indicated that the plan terms should be controlling in this situation. If the plan document uses the general high 25 language, then the plan could not limit the determination of the highest paid 25 employees to the last 6 years, since the plan would not provide for such a limitation.

8. §401(a)(4) - HIGHEST PAID 25 EMPLOYEES.  
Is it necessary to obtain a private letter ruling in order to use an escrow arrangement with an IRA to satisfy the high 25 rules?

PROPOSED ANSWER. Treasury Regulations § 1.401(a) (4)-5(b) (1) states that the High 25 rules "do not apply if the Commissioner determines that such provisions are not necessary." It appears that the only way to obtain such a determination is by means of a private letter ruling.

IRS RESPONSE: The regulatory provision is discussing a waiver of the high 25 restrictions, which the IRS does not anticipate waiving in the future. An escrow agreement is a different matter and doesn't need a private letter ruling. The plan document must contemplate the escrow provision. In response to a question, the IRS indicated they are currently not permitting plans to omit the high 25 language, but may
be possible if none of the high 25 employees can participate in the plan or if no
distribution option in the plan would distribute benefits faster than the restricted option
under the high 25 rules.

9. §401(a)(4) - HIGHEST PAID 25 EMPLOYEES
The term "Restricted Employee" in Treasury Regulation Section 1.401(a)(4)-5(b)(3)(ii)
(relating to the high-25 rule) is not limited to participants in the plan. Is it possible
that none of the Restricted Employees are actually participants?

PROPOSED ANSWER: The identity of the Restricted Employees is determined without
regard to their participation in the plan, just like the determination of who are the
highly compensated employees and who are the highly compensated employees.

IRS RESPONSE: The IRS agrees with the proposed answer. The high 25 determination
is made based on the employer's total workforce without regard to whether the
employees are participants in the plan.

10. §401(a)(9) - MINIMUM DISTRIBUTIONS
If an IRA account holder has commenced distributions under Section 401(a)(9)
following his required beginning date and dies after receiving the required minimum
distribution for the year in which death occurs, must the decedent's estate be paid the
required minimum distribution for the following calendar year if the rollover by the
surviving spouse is not completed by the close of the calendar year in which the
decedent's death occurs (i.e. IRA account owner dies December 20, 1993 after
receiving 1993 minimum, spouse doesn't complete rollover until January 15, 1994, can
1994 required minimum be paid in accordance with life expectancies applicable to
spouse's rollover IRA instead of 1994 required minimum to decedent's estate)?

PROPOSED ANSWER: Distribution for calendar years immediately following first
account owner's death should be made in full to spouse, based on spouse's life
expectancy, notwithstanding that the rollover is not made until after first day of the
next year.

IRS RESPONSE: IRS assumes the spouse is the designated beneficiary, so payments
should be made to spouse and not estate. IRS reviewed special rules under 401(a)(9)
for surviving spousal beneficiaries which allow spouse to treat IRS has his or her own.

11. §401(a)(11) - QUALIFIED JOINT AND SURVIVOR BENEFITS
How is an individual's status as a spouse to be determined for purposes of the spousal
consent rules under section 401(a)(11) and 417? Specifically, if a couple has divorced
under the laws of a foreign country and the state in which they reside recognizes
foreign divorces for limited purposes only, would the couple be deemed married for purposes of the spousal consent rules? Would it depend on the purposes for which the state recognized the foreign divorce? If so, would the couple be considered divorced for purposes of the spousal consent rules if the state in which they reside recognizes foreign divorces solely for purposes of determining property rights?

PROPOSED ANSWER. If the state recognizes foreign divorce (i.e., many states recognize such divorce if bilateral, that is, both parties to the divorce consented and were represented at the proceeding), the foreign divorces should be acceptable for purposes of the spousal consent requirements.

IRS RESPONSE: The IRS believes the determination of marital status is a matter of state law. If state law would consider a couple divorced for some purposes but not for others, the IRS is likely to follow the determination of whether the couple is divorced for property right purposes.

12. §401(a)(17) - COMPENSATION LIMITATION
Can a plan have a fresh start only for the 401(a)(17) employees, instead of all plan participants, and adjust their frozen accrued benefits for increases in the compensation limitation?

PROPOSED ANSWER. Yes. Treas. reg. 1.401(a)(17)-1(e)(3)(ii) incorporates all the requirements of the fresh start rules under 1.401(a)(4)-13(c) and (d) in order to adjust the frozen accrued benefits of 401(a)(17) employees. While 1.401(a)(4)-13(d)(4) requires that the group of employees with accrued benefits under the plan as of the fresh start date must satisfy a minimum coverage requirement, this is not a requirement that the fresh start group satisfy a minimum coverage requirement. As long as the total group of employees with accrued benefits under the plan satisfy a minimum coverage requirement, the fresh start can cover a smaller, select group of those employees. Additionally, while treas. reg. 1.401(a)(4)-13(d)(5) requires that a fresh start group satisfy a minimum coverage test in order to adjust the frozen accrued benefit for increases in compensation, that rule does not apply to fresh starts before the effective date of the 401(a)(4) regulations, which is the first day of the plan year beginning in 1994. Since a 401(a)(17) fresh start would occur on the last day of the 1993 plan year, a 401(a)(17) fresh start satisfies this requirement.

The evidence of this is the model amendment under Rev. Proc. 94-13, in which Part II of the model amendment applies the fresh start only to the 401(a)(17) employees, and Part III of the model amendment adjusts the frozen accrued benefits of the 401(a)(17) employees.

IRS RESPONSE: The IRS agrees with the proposed answer. Provision intended for situations where only fresh start needed is for 401(a)(17) employees.
13. §401(a)(17) - COMPENSATION LIMITATION
Can a plan be amended in 1994 to retroactively change the benefit accrual formula for 1993 and prior years? For example, can a plan change its benefits accrual formula from a 2% of final average pay to 2 1/2% of final average pay for all years in the good faith transition period? Does the answer change if the plan has not yet been amended to comply with TRA'86.

PROPOSED ANSWER. A plan can be amended in 1994 to retroactively change its benefit accrual formula for 1993 and prior years without violating the 1994 compensation limit under section 401(a)(17) of $150,000. While 401(a)(17) prohibits the accrual of benefits in 1994 using compensation in excess of $150,000, the retroactive change in benefit formulas is not an accrual of benefits in 1994 for these purposes. The retroactive change in benefit formula is a past service benefit, and can consider compensation up to the limit in effect for the year the past service was earned. The answer does not change depending on whether the plan has been amended to comply with TRA'86.

IRS RESPONSE: Amendments made within the 401(b) remedial amendment period can increase benefits, because the remedial amendment period treats the plan as if it had been amended in 1989, not 1994. In response to a question, the IRS indicated the timing of the amendment for funding and deduction purposes would be governed by 412(c)(8), and not by the 401(b) remedial amendment period.

14. §401(a)(17) - COMPENSATION LIMITATION
If a frozen plan is amended mid-year to resume benefit accruals, can a full plan year of compensation be used for purposes of Section 401(a)(17) provided the plan year is the twelve month period?

PROPOSED ANSWER: Since the plan year is a full twelve month period, no proration should be required per Treas. Reg. §1.401(a)(17)-1(b)(3)(iii)(B).

IRS RESPONSE: The answer depends on how the plans benefit accrual provisions work. A career average plan which bases benefit accrual for the year only on the six month period after the plan is unfrozen would need to prorate the compensation limitation. A final average pay plan which bases benefits on the entire year's compensation would not need to prorate the compensation limit.

15. §401(a)(17) - COMPENSATION LIMITATION AND LIMITATION ON BENEFITS
401(a)(17) was amended by OBRA '93 to require that the "annual compensation of each employee taken into account under the plan for any year does not exceed $150,000." 415(b)(1)(B) limits the annual benefit payable under a defined benefit
plan to "100 percent of the participant's average compensation for his high 3 years."
Does the 401(a)(17) compensation limitation limit the benefit payable to the participant
under the 415(b)(1)(B) compensation limitation?

For example, Employee A is an active employee with 40 years of service who was age
68 in 1993 and has had total compensation of $300,000 for many years. His employer
sponsors a defined benefit plan with a benefit formula of 2% of final average pay time
years of service, with a maximum of 40 years of service. For 1993, the benefit
payable to Employee A before application of the 415 limits is $188,672, or 80% of the
participant's final average compensation limited to the 1993 401(a)(17) compensation
limit of $235,840 (assuming the plan sponsor is using the reasonable, good faith
transition rule of applying the 1993 limit for all prior years, and that the employer is
using the fresh start rule with wear-away). For 1993 Employee A's 415(b) limit was
$158,291 (the 1993 415(b)(1)(A) limit of $115,641 actuarially increased for his age
68). Because he already has 40 years of service, Employee A will not accrue a benefit
in 1994. Is the benefit payable on December 31, 1994: (1) $181,782 (the 1994
415(b)(1)(A) limit of $118,800 actuarially increased to age 69), (2) $158,291, or (3)
$150,000?

PROPOSED ANSWER: The benefit payable on 12/31/94 should be $181,782, the 1994
414(b)(1)(A) limit of $118,800 actuarially increased to age 69. The 401(a)(17)
compensation limit does not apply for purposes of section 415(b)(1)(B). The
compensation limit generally applies for nondiscrimination purposes, not the benefits
limits under 415. Reg. 1.401(a)(17)-1(c)(1) indicates that the compensation limit
applies for purposes of sections 401(a)(4), 401(a)(5), 401(l), 401(k)(3), 401(m)(2),
403(b)(12), and 410(b)(2). There is no mention in the 401(a)(17) regulations
concerning section 415.

IRS RESPONSE: This answer depends on plan drafting. But the IRS believes the plan
sponsor should be able to draft around the problem.

16. §401(a)(17) - COMPENSATION LIMITATION AND 401(K) PLANS
How does the compensation limitation of IRC § 401(a)(17) apply in the case of a
401(k) plan in which the deferrals and match are made monthly? For example,
assume an employee whose annual compensation is $300,000 ($25,000 per month)
participates in a 401(k) plan which permits employee deferrals of 6% of compensation
per month with a 100% monthly match.

Proposed Treasury regulation § 1.401(a)(17)-1(b)(3)(iii)(A) provides that if
compensation for a period of less than twelve months is used for a plan year, then the
otherwise applicable annual compensation limit is reduced in the same proportion as
the reduction in the 12-month period. An example is given of a defined benefit plan
that provides for separate monthly accruals based on the compensation for that month
with the plan year accrual to be the sum of the monthly accruals. The proposed
regulation states that the annual compensation limit for each month is 1/12 of the
annual compensation limit for the plan year.

Proposed Treasury regulations § 1.401(a)(17)-1(b)(3)(iii)(B) provides that a plan is not
treated as using compensation for less than 12 months for a plan year merely because
the plan formula provides that the allocation or accrual for each employee is based on
compensation for the portion of the plan year during which the employee is a
participant in the plan.

PROPOSED ANSWER: Either of the following two alternative approaches satisfy the
IRC § 401(a)(17) limitation to the fact situation described above:

Approach 1: The employee's full compensation of $25,000 per month is taken
into account until total compensation of $150,000 has been taken
into account. Thus the employee would be able to contribute
$1,500 per month ($25,000 x.06) and receive a monthly match
of $1,500 for the first six months of the year at which time he
would be prevented from further participation in the plan.

Approach 2: The employee's monthly compensation taken into account under
the plan would be 1/12th of the annual IRC § 401(a)(17) limit of
$150,000 or $12,500. The employee would be allowed to
contribute $750 per month ($12,500 x .06) and receive a
monthly match of $750 for the entire year.

IRS RESPONSE: The IRS agrees with the proposed answer. There is no requirement
to prorate the compensation limit. The requirement for prorating the limit is intended
to plan years less than 12 months, and not merely because the amount of 401(k)
elective deferrals are determined on the basis of each payroll period. Additional
guidance on this issue will be added to the final 401(a)(17) regulations.

17. §401(a)(17) - COMPENSATION LIMITATION AND 401(K) PLANS
If the proposed answer to the prior question is correct and Approach 1 is being used,
would it be permissible for the employee to suspend participation in the plan during
the first six months of the year and rejoin the plan on July 1, contributing $1,500 per
month?

PROPOSED ANSWER: Yes.

IRS RESPONSE: The IRS agrees with the proposed answer. While there is no
violation of 401(a)(17), the ability to change a participant's election during the middle
of the year is a right or feature of the plan which cannot be available only the
401(a)(17) employees.

18. §401(a)(26) - MINIMUM PARTICIPATION REQUIREMENTS - MULTIEMPLOYER PLANS
Treas. reg. 1.401(a)(26)-1(b)(2)(ii) provides a special rule for determining whether a multiemployer plan which benefits both collectively bargained employees and employees who are not included in a unit of employees covered by a collective bargaining agreement ("noncollectively bargained employees") satisfies the requirements of Code section 401(a)(26). The regulation provides that while the portion of a multiemployer plan that provides benefits for an employer's noncollectively bargained employees must separately satisfy section 401(a)(26), that portion of the plan will satisfy section 401(a)(26) if the plan benefits 50 employees. The regulation indicates that "for purposes of this special testing rule, employees who are included in a unit of employees covered by a collective bargaining agreement may be included in determining whether the plan benefits 50 employees." Must the collectively bargained employees who may be included under such special rule be employed by the same employer who employs the noncollectively bargained employees with respect to whom compliance with section 401(a)(26) is being tested?

PROPOSED ANSWER. No. The intent of the regulation, if not the literal meaning, is that all collectively bargained employees may be included even though they are not employed by the employer who employs the noncollectively bargained employees being tested. This is consistent with what appears to be the approach taken in the final regulations, that sections 410(b) and 401(a)(4) and the regulations thereunder provide sufficient rules to determine whether the portion of a multiemployer plan that provides benefits for an employer's noncollectively bargained employees discriminates in favor of highly compensated employees.

IRS RESPONSE: The IRS agrees with the proposed answer. The deemed pass applies if the plan covers 50 employees, because the IRS was sensitive to concerns about how the multiemployer plan could monitor satisfaction of the minimum participation rules.

19. §401(k) - CASH OR DEFERRED ELECTIONS
A new employee of Employer A agrees in writing prior to the date on which he become an employee of Employer A not to participate in a retirement plan, intended to satisfy the qualification requirements of section 401(a) of the Internal Revenue Code, maintained by Employer A for a specified period of time (e.g., the first three years of his or her employment). Upon expiration of this specified period of time, the employee will become a participant in the plan. Is such a one time irrevocable election treated as a cash or deferred election under section 1.401(k)-1(a)(3) of the Treasury Regulations?
PROPOSED ANSWER: Section 1.401(k)-1(a)(3)(iii) of the Treasury Regulations provides that a cash or deferred election does not include a one time irrevocable election where the employee may elect on commencement of employment or upon first becoming eligible under any plan of the employer to have a specified amount of percentage of compensation contributed by the employer (on behalf of the employee) to the plan for the duration of the employee's employment with the employer. Contributions made by the employer pursuant to such a one time election are not treated as having been made pursuant to a cash or deferred arrangement.

Because the employee's election is made prior to the date on which he is first eligible to participate in the plan and because the election is irrevocable, the election should not be treated as a cash or deferred election under section 1.401(k)-1(a)(3) of the Treasury Regulations.

IRS RESPONSE: The IRS disagrees with the proposed answer. The regulations require the one time election to be for the duration of the employee's employment. An election for a fixed duration of time is not satisfactory.

20. §401(k) - CASH OR DEFERRED ARRANGEMENT
Treas. reg. 1.401(k)-1(a)(6)(ii) provides that a cash or deferred arrangement "includes any arrangement that directly or indirectly permits individual partners to vary the amount of contributions made on their behalf." Treas. reg. 1.401(k)-1(a)(3)(iv) provides that a cash or deferred election does not include amounts contributed to a plan pursuant to a "one-time irrevocable election upon an employee's commencement of employment with the employer or upon the employee's first becoming eligible under any plan of the employer. . ." If a profit sharing plan covering all of the employees and partners of a partnership permits only partners to make such a one-time irrevocable election, will such an election by a partner, who had previously been an employee and as such participated in the plan, be considered to be a cash or deferred election?

PROPOSED ANSWER. No. While the election is made subsequent to the individual's "commencement of employment with the employer" and the individual's "first become eligible under any plan of the employer" . . ."at the time of employment and first becoming eligible, an election by the individual, because she is not a partner, does not know whether she will become a partner, or, even if she assumes that she will become a partner, she has insufficient information to predict her economic situation 5 or 10 years in the future and the election would be based on incomplete information. Thus, any election prior to the time the individual becomes a partner would be meaningless.

IRS RESPONSE: The IRS disagrees with the proposed answer. The one time election must be made before the individual first becomes eligible under the plan.
21. §401(k) - CASH OR DEFERRED ARRANGEMENT

A company maintains a qualified defined benefit plan for its union employees. It proposed to establish a profit sharing plan for these union employees under which the company will contribute the amount which the employees have elected to defer on a pre-tax basis under a one-time irrevocable election plus a matching contribution based on the employee's deferrals. Employees who make the one-time irrevocable election upon first becoming eligible to participate in the profit sharing plan must also agree to cease participation in the defined benefit plan. Will the profit sharing plan be qualified and not be deemed to contain a cash or deferred election?

PROPOSED ANSWER. Since the union employees will have a one-time change to make a deferral election that is irrevocable, and which will continue for the duration of the employee's employment, the election meets the requirements of reg. 1.401(k)-1(a)(3) and therefore is not treated as a cash or deferred election. The use of the word "any" in the phrase "upon the employee's first becoming eligible under any plan of the employer" must be interpreted to mean the first time an employee is given the right to make a one-time election (as opposed to the first time the employee is eligible under a plan that does not allow one-time elections), otherwise a company that has a qualified plan could never adopt a new plan that allows one time elections with respect to employees who currently participate in the company's plan. Since this one-time election is not a chase or deferred election, the profit sharing plan will not be deemed to contain a cash or deferred arrangement and therefore the prohibition against making benefits contingent upon salary deferrals in reg. 1.401(k)-1(e)(6) is not applicable and the plan would be a qualified profit-sharing plan.

IRS RESPONSE: The IRS disagrees with the proposed answer. The one time election must be made before the employee's first becoming eligible under any plan of the employer, including the defined benefit plan. In response to a question, the IRS indicated the prior plan participation requirement was limited to qualified plan participation.

22. §401(k) - CASH OR DEFERRED ARRANGEMENT

A company maintains a 401(k) plan with a match for its salaried employees and a defined benefit plan for its union employees. As part of its recent union negotiations, the company agreed that union employees hired after the effective date of the collective bargaining agreement ("new hires") would not be eligible to participate in the defined benefit plan but instead would participate in the 401(k) plan and receive the company match. The company also agreed to allow current union employees to participate in the 401(k) plan. Of the current union employees, those who voluntarily elected to waive participation in the defined benefit plan will receive a matching contribution in the same amount as the non-union employees and new hires who participate in the 401(k) employees. If the plan is amended to provide matching
contributions for current union employees who waive participation in the defined benefit plan, will the plan violate the contingent benefit rule?

PROPOSED ANSWER. The contingent benefit rule allows matching contributions to be contingent upon elective contributions. The one-time election to cease participation in the defined benefit plan is not a benefit contingent upon elective contributions and therefore the 401(k) plan does not violate the contingent benefit rule.

IRS RESPONSE: The IRS disagrees with the proposed answer. The IRS views the contingent benefit rule very broadly. Participation in the defined benefit plan is contingent on participation in the 401(k) plan, which violates the contingent benefit rule.

23. §401(k) - CASH OR DEFERRED ARRANGEMENT
A company maintains a 401(k) plan with a match. The participants in the plan may direct the investment of their monies among three investment funds, one of which is a stock fund that invests in the stock of the company. The company also maintains an after-tax stock purchase program qualified under the Internal Revenue Code. The company would like to add to the stock purchase program a matching contribution equal to that provided under the 401(k) plan. The company would further amend the stock purchase plan to provide that only employees who are not eligible to participate in the 401(k) plan or who choose not to make deferrals under the 401(k) plan may participate in the stock purchase program. Employees who choose to participate in the 401(k) plan would be prohibited from participating in the stock purchase program since such participation would give them the benefit of both matches. Would this arrangement violate the contingent benefit rule?

PROPOSED ANSWER. The 401(k) plan would be qualified since it is the participant's ability to participate in the stock purchase plan which is being restricted, not a benefit being conditioned upon a participant's salary deferrals.

IRS RESPONSE: The IRS disagrees with the proposed answer. Participation in the stock purchase plan is contingent on participation in the 401(k) plan, which violates the contingent benefit rule.

24. §401(m) - EMPLOYER MATCHING CONTRIBUTION.
A 401(k) plan provides an accrual of benefit for the employer matching contribution based on years of service, as follows:

- Less than 10 years: 40%
- 10 to 24 years: 50%
- 25 years or more: 60%
Do benefits under the plan have to be tested separately, for non-discrimination purposes, with respect to the accrual of the matching contribution.

PROPOSED ANSWER. No. The exclusive nondiscrimination test for an employer matching contribution is the Average Contribution Percentage test under section 401(m). Treas. reg. 1.401(a)(4)-1(b)(2)(ii)(B). However, the different rates of matching contributions are separate rights and features which must be currently and effectively available to nondiscriminatory groups of employees. Treas. reg. 1.401(a)(4)-4(e)(3)(iii)(G).

IRS RESPONSE: The IRS agrees with the proposed answer. There are two, but only two nondiscrimination tests for the matching contributions.

25. §402(c) - ROLLOVER CONTRIBUTIONS
Can employees make rollover contributions prior to being able to participate in the plan? See Rev. Rul. 68-651, 1968-2 C.B. 167.

PROPOSED ANSWER. Inasmuch as the Internal Revenue Service has recognized that a plan may have different eligibility conditions for the different features offered under a plan, and the ability to make rollover contributions is simply another feature, there does not appear to be any policy reason precluding plans from allowing employees to make rollover contributions prior to the date on which they are eligible to make pre-tax employee contributions and/or receive allocations of employer contributions.

IRS RESPONSE: The IRS agrees with the proposed answer. A plan can accept rollover contributions prior to plan participation.

26. §408 - SIMPLIFIED EMPLOYEE PENSION LIMITATIONS
Code section 402(h)(2)(B) effectively provides that the section 415 dollar limitation for a highly compensated employee in an integrated Simplified Employee Pension will be reduced by "the amount taken into account with respect to such employee" under section 401(l)." What is "the amount taken into account?"

PROPOSED ANSWER: For this purpose, the "amount taken into account" is the amount of excess compensation times the difference between the base and excess benefit percentages.

IRS RESPONSE: The IRS disagrees with the proposed answer. The "amount taken into account" is the amount of compensation up to the integration level times the difference between the base and the excess benefit percentages. For example, a plan with a formula of 10% of compensation up to the integration level, with 12% of compensation over the integration level. The amount taken into account is 2% of
compensation up to the integration level.

27. §410(b) - MINIMUM COVERAGE REQUIREMENTS
Under Treas. Reg. §1.410(b)-6(b)(3) a plan which benefits otherwise excludable employees may be treated as two plans. The regulation states that this rule allows the plan to treat employees as excludable even though the plan does not apply the greatest permissible minimum age and service conditions. If the plan imposes multiple age and service conditions for different divisions and one division applies the greatest permissible minimum age and service condition, can the plan still utilize -6(b)(3)?

PROPOSED ANSWER: Yes. The fact that any employees benefit under a plan who would otherwise be excludable if the plan applied the greatest permissible minimum age and service conditions should entitle the plan to utilize -6(b)(3).

IRS RESPONSE: The IRS agrees with the proposed answer.

28. §410(b) - MINIMUM COVERAGE REQUIREMENTS
If an employer permissively aggregates two plans with different age and service conditions, can the employer then apply Treas. Reg. §1.410(b)-6(b)(3) to create a separate plan which benefits otherwise excludable employees. Does this violate Treas. Reg. §1.410(b)-7(d)(2) which prohibits aggregation of two or more separate plans disaggregated pursuant to §1.410(b)-7(c)(3)?

PROPOSED ANSWER: An employer can permissively aggregate two plans then disaggregate that portion of the combined plan which benefits otherwise excludable employees.

IRS RESPONSE: The IRS agrees with the proposed answer.

29. §410(b) - MINIMUM COVERAGE REQUIREMENTS
Assume that a 401(k) plan cannot satisfy 410(b) minimum coverage requirements in 1994. In order to satisfy the coverage requirements under the ratio percentage test, the plan is amended during the second quarter of 1994 to prohibit participation by shareholder-employees and certain other highly compensated employees effective on the date the amendment is adopted. Can the plan be tested for 1994 for coverage on a snapshot date that is after the effective date of the amendment and exclude from consideration in testing the newly excluded HCEs?

PROPOSED ANSWER: Since the amendment is effective before the end of the 1994 plan year, it is not a retroactive corrective amendment for a prior plan year under reg. 1.401(a)(4)-11(g). Therefore, the plan should be able to correct coverage by some means other than additional contributions for non-HCEs or adding previously excluded
non-HCEs as would be required in the case or a retroactive amendment for a prior plan year which has already ended.

IRS RESPONSE: The IRS disagrees with the proposed answer. Snapshot testing assumes there are no significant changes after the snapshot date, and here there are changes in the plan's coverage. Additionally, the correction mechanism requires adding nonhighly compensated employees or increasing their benefits, not eliminating HCEs.

30. §411 - CHANGE IN VESTING SCHEDULE
Employer A maintains Plan A, a 401(k) plan with an employer match that is 100% vested. Employer B maintains Plan B, a 401(k) plan with a graded vesting schedule for employer matching contributions. Employer B acquires Employer A and Plan A is merged into Plan B. May future employer matching contributions to accounts for former Plan A participants be made subject to a graded vesting schedule? Must all participants with three years of service in Plan A be permitted to elect the continued use of the 100% vesting schedule for their future matching contributions?

PROPOSED ANSWER: 411(a)(10)(A) requires that if any plan amendment changes a vesting schedule under the plan, it does not satisfy the requirements of 411(a)(10)(A) if the nonforfeitable percentage of the accrued benefit derived from employer contributions (such percentage being determined as of the later of the date the amendment is adopted, or the date such amendment becomes effective) of any employee who is a participant in the plan is less than such nonforfeitable percentage computed without regard to such amendment. The regulation does not clearly state that the employer-derived accrued benefit "as of the date of such amendment" is the only benefit subject to the requirements of the rule. However, the Conference Report on ERISA includes the following statement:

The [bill] provides that if, at any time in the future, the plan changes its vesting schedule, the vesting percentage for each participant in his accrued benefit accumulated to the date when the amendment is adopted (or the date the amendment becomes effective, if later) cannot be reduced as a result of the amendment.


An example contained in the Alert Guidelines Explanation No. 2, Minimum Vesting Standards for Defined Contribution Plans, published by the IRS, appears to apply the rule more broadly, and suggest that the plan vesting schedule in existence at the time of the amendment must be applied with respect to all future employer-derived accrued benefits for a participant in the plan prior to the amendment.
It appears clear that the provisions in 411(a) regarding amendments to the vesting schedule apply equally to changes that occur not by reason of plan amendment, but because of a merger or other similar transaction. See Reg. 1.411(d)-4, Q&A 2(a)(3)(i).

The statutory provision in 411(a)(10)(B) requires that a plan amendment changing any vesting schedule does not satisfy the requirements of 411(a)(2) unless each participant having not less than three years of service is permitted to elect to have his or her vesting percentage computed under the plan without regard to such amendment. It seems clear that this provision applies equally to a plan merger or other transaction having the effect of amending a vesting schedule.

IRS RESPONSE: The IRS disagrees with the proposed answer. The elected vesting percentage should apply to future accruals. While the guidance is not particularly clear, the IRS’s position is clear on this issue. In response to a question, the IRS indicated that this treatment was different than a partial termination, in which case the full vesting required by the partial termination would only apply to the accrued benefit at the time of the partial termination.

31. **§411 - PARTICIPANT CONSENT**

Is it a significant detriment within the meaning of the consent requirement for distributions (See Treas. Reg. §1.411(a)-11(c)(2)(i)) to limit in-service distributions to active employees, to limit the investment options available to a terminated participant, or to purchase a deferred irrevocable annuity for any participant who does not consent to an immediate distribution?

PROPOSED ANSWER: Yes, all of the foregoing provisions constitute a significant detriment.

IRS RESPONSE: The IRS agrees with the proposed answer. Any distinction between active employees and separated employees which would be considered an economic inducement to take an immediate distribution is a significant detriment. The IRS recognizes that most of these provisions are plan document provision, and IRS determination letters may have been issued for plans which contained such inducements. In response to a question, the IRS indicated that the availability of plan loans to former employees may be different because there is no opportunity for salary repayment of the loan by a former employee. Another example of a significant detriment would be when only active employees could hold employer stock in their account, or charging former employees fees for plan administration or investment fees. If benefit options are available to active employees that are not available to former employees, the answer may depend on the number of benefit options not available to former employees and whether there are economic reasons for the distinction.
32. §411(b) - Benefit Accrual Rules
Assume that a plan provides for one formula for pre-1989 benefits and a completely different formula for post-1989 benefits. Can the plan use a different benefit accrual rule under Section 411(b) for the different segments?

PROPOSED ANSWER. Different benefit accrual rules can be used for pre-1989 and post-1988 benefits. This approach is consistent with the fresh start rules of the Section 401(a)(4) regulations.

IRS RESPONSE: The accrual rules are a minimum requirement applicable to the plan; how the pieces of the formula get there is a plan design issue. Whether the accrual rules are satisfied depends in part on which accrual rule is met - the 133% rule may be met by a fresh start rule under circumstances in which the fractional accrual rule would not be satisfied. Not that the DB LRM for fractional accrual rule requires wear away or extended wear away, in response to IRS concerns about the accrual rules.

33. §411(d)(6) - Anti Cutback Rule
May an employer amend a profit sharing plan which has provided that a qualified joint and survivor annuity will be the normal form of benefit so that it provides that the qualified joint and survivor annuity is one of the optional forms which may be chosen?

PROPOSED ANSWER: Many profit sharing plans contain distribution provisions which make the qualified joint and survivor annuity (QJSA) the normal form of benefit payment. This is not required by Code Section 401(a)(11) but results in prior drafting decisions. To simplify plan administration, one clearly acceptable method of eliminating the QJSA as the normal form of benefit is to terminate the plan, establish a new plan and roll over the benefits into a successor plan which does not contain this provision. This is a remedy which is far too expensive and has other unfavorable results for plan participants. Another approach is to amend the plan to eliminate the QJSA as the normal form of distribution with respect to benefits accrued after the date of the amendment. While this is effective for new participants, it requires the plan administrator to maintain two sets of administrative procedures and creates more opportunity for confusion and error.

Code Section 411(d)(6) prohibits a plan amendment which has the effect of eliminating an optional form of benefit. Changing the QJSA from the normal form of benefit to one of the optional forms would not eliminate the QJSA. Further, it would not have any adverse effects on the rights of the plan participant. However, it would have the effect of eliminating the spouse's right as to choice of form, to the extent that a non-annuity form of payment was selected by the participant.

Reg. §1.411(d)-4 Q&A 1(d) gives several examples of items that are not protected benefits. One example of an excluded item is "administrative procedures for
distributing benefits, such as provisions relating to the particular dates on which notices are given and by which election must be made."

Changing the QJSA from the normal form of benefit to an optional form of benefit does not eliminate the benefit option and preserves the election right, to the extent that an annuity is desired by the plan participant. The change in the plan operation is in the nature of "administrative procedures for distributing benefits" and not in the nature of an elimination of an optional form of benefits.

An amendment to a plan which substitutes a lump sum form of distribution as the normal form of benefit in place of a QJSA is not prohibited by Code Section 411(d)(6) as long as the QJSA is retained as one of the optional distribution forms.

**IRS Response:** The IRS indicated that the anti-cutback rule of section 411(d)(6) may not protect whether a benefit is the normal form of benefit or not, but the spousal consent rules might control in this situation. The spousal consent rules require such consent for a non-QJSA distribution from a profit sharing plan if the participant has elected an annuity distribution option. The IRS considers having a joint and survivor annuity option as the normal form of benefit which the participant would receive by default as an election by the participant for these purposes, so spousal consent would be required for any distribution from the plan. In response to a question, the IRS indicated this is a change in position from prior years.

34. **§417(e) - Determination of Lump Sums**
Can a plan use PBGC male mortality tables in connection with PBGC interest rates for purposes of Section 417.

**Proposed Answer.** The regulations do not preclude a plan from using the male tables. Accordingly, it should be permissible.

**IRS Response:** 417 does not prescribe any mortality tables. Any table can be used, as long as it was reasonable. Because this is a potential forfeiture mechanism, the PBGC reform legislation proposes mandating a mortality table, but there is no preclusion against using the PBGC tables currently.