AMERICAN BAR ASSOCIATION
SECTION OF TAXATION
MAY MEETING 1995

COMMITTEE ON
EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS
INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

MAY 19, 1995
1. **Section 125 Cafeteria Plans.**
Who is a qualified beneficiary for purposes of electing to contribute on an after-tax basis to a section 125 health care flexible spending account upon the occurrence of a COBRA qualifying event?

For example, Employee X elects to contribute $1,200 to a health care flexible spending account in 1995, with $100 per month to be withheld from her pay. Employee X and her spouse are divorced on June 30, 1995. Is employee X the sole qualified beneficiary under a health care flexible spending account or is the former spouse “a beneficiary under the plan” with a right to elect to continue to participate in the account? If the latter, what is the amount the former spouse can elect to contribute to the health care flexible spending account for the remainder of 1995?

**PROPOSED RESPONSE.** The employee electing to participate in a health care flexible spending account is the sole participant in the plan. The right to reimbursement of health care expense is personal to the employee, although the expenses may be incurred by the employee’s spouse and dependents.

**IRS RESPONSE.** The IRS disagreed with the proposed response. Both the employee and her spouse are qualified beneficiaries and both are entitled to make independent COBRA elections. Both individuals are entitled to FSAs equal to amount of X’s initial election ($1200) minus any reimbursements made to date. However, both X and spouse must individually continue make the future $100 FSA premium and COBRA premium.

2. **Section 125 - Cafeteria Plans.**
Assume that a cafeteria plan allows the payment of premiums under an indemnity plan to be made on a pre-tax basis. Assume further that the employer wants to add an HMO part way through the year. Can the employees switch coverage to the HMO and the amount of their premiums paid through the cafeteria plan be appropriately modified at that time as a result?

**PROPOSED RESPONSE.** Yes. The purpose of the rule precluding changes during a plan year was to preclude participants from “gaming” the system. In this case, the participants had no choice as to the implementation of the HMO, so that they should be allowed to change their elections during the year.

**IRS RESPONSE.** The IRS disagreed with the proposed response. The participants would be permitted to switch to the HMO, but they are not permitted to change their pre-tax contributions. If the HMO costs more than the indemnity plan, the employees must pay that difference with after-tax dollars, but if the HMO costs less than the indemnity plan, the employees must forfeit that difference.

3. **Section 125 - Cafeteria Plans.**
Assume that, due to financial difficulties, an employer must reduce the amount of its subsidy to its health plan mid-year. Can participants in the employer’s cafeteria plan increase their contributions to make up the difference?

**PROPOSED RESPONSE.** Yes. The purpose of the rule precluding changes during a plan year was to preclude participants from “gaming” the system. In this case, the decision to reduce the subsidy was made by the employer, not the participants, so that they should be allowed to change their elections during the year.

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IRS RESPONSE. The IRS disagreed with the proposed response. Employees must pay the additional premiums amounts on an after-tax basis.

4. Section 125 - Cafeteria Plan.
Would a spouse becoming eligible for Medicare benefits constitute a change in family status permitting a change in elections under a cafeteria plan?

PROPOSED RESPONSE. Yes. That is a valid change in family status.

IRS RESPONSE. The IRS disagreed with the proposed response. In the situation described, no change in family status has occurred and the Medicare benefits are not attributable to the spouse's employment.

5. Section 162(m) - Million Dollar Deduction Limit.
How is the valuation of stock for purposes of stock option fair market value grants to be done? For example, in private to public scenarios, such as by spin-off, exchange or initial public offering or otherwise, in the case of options intended to be granted at “fair market value” on the "initial public trading date” reasonable approaches include (i) the initial price at which securities are sold to the public, (ii) a 10 day forward trading average or (iii) an appraisal.

PROPOSED RESPONSE. Any of the above methodologies is satisfactory if adopted in good faith.

IRS RESPONSE. The IRS agreed with the proposed response. Use of hindsight should not be a factor, the method should be set in advance and whether it was reasonable or not would be based on the facts and circumstances at that time. These methods sound pretty reasonable in most situations.

6. Section 162(m) - Executive Compensation Deduction Limit.
When restricted stock is granted based on achievement of performance goals, is it sufficient for the plan to contain a limit on the number of shares that can be awarded, or must there also be a dollar limit? Does it make a difference if the formula for determining the number of shares to be awarded includes salary as a factor?

PROPOSED RESPONSE. Although section (e)(4)(i) of the proposed regulations states that a maximum dollar amount must be stated where the formula is based in whole or part on a percentage of salary, it appears that a limit on the maximum number of shares that can be awarded should be sufficient in this situation. It is similar to stock options, where a share limit is expressly permitted, in that the ultimate value of the award will depend on the future value of the stock, and the shareholders can estimate that value.

IRS RESPONSE. The IRS agreed with the proposed response. A dollar limit is not required, you only need the number of shares, which translates into a formula for people to know what is the maximum amount that can be paid.

7. Section 280G - Golden Parachute Payments.
Can the excise tax on golden parachutes be avoided by a binding contractual obligation that the executive is required to repay (with interest) any amounts he or she received that are subject to the tax (i.e., retroactively characterizing those amounts as a loan)?

**PROPOSED RESPONSE.** No. The tax consequences of a transaction are determined at the time it occurs; subsequent events cannot change its status.

**IRS RESPONSE.** The IRS agreed with the proposed response.

8. **Section 208G - Golden Parachute Payments.**

Proposed reg. 1.280G-1, Q&A-34 states that an executive's base amount is determined by reference to average annual compensation, which is the amount includible in gross income. Thus, this amount would not include, inter alia, deferrals under section 401(k).

On the other hand, Proposed reg. 1.280G-1, Q&A-21 states that compensation is determined without regard to sections 125, 402(a)(8), and 402(h)(1)(B). Thus, deferrals under section 401(k) are taken into account.

To further complicate things, Question 34 cross-refers to the definition of compensation set forth in Question 21. Is compensation correctly limited to amounts includible in compensation, or can it be determined without reference to sections 125, 402(a)(8), and 402(h)(1)(B).

**PROPOSED RESPONSE.** Question 21 is more detailed and specific, so it should control. Therefore, amounts subject to sections 125, 402(a)(8), and 402(h)(1)(B) should be taken into account.

**IRS RESPONSE.** The IRS agreed with the proposed response.

9. **Section 280G - Golden Parachute.**

Assume a stock option was granted more than a year before a change of control and has fully vested prior to the change of control. The option by its terms terminates a specified number of months following termination of employment. If the option is exercised following a change of control, is the spread on exercise a parachute payment?

**PROPOSED RESPONSE.** No. The fact that the option terminates on termination of employment does not make it "unvested". Thus the fact that the option is exercised following a change of control does not mean that it becomes "vested" as a result of the change of control. Prop. reg. 1.280G-1, Q&A 24, Ex. 2 describes a vested SAR exercised following a change of control and states that no portion of the amount received upon exercise of the SAR is contingent upon the change in control. The only difference in our option example is that the option is expressly stated to terminate upon termination of employment, a fact not stated in the SAR example.

**IRS RESPONSE.** The IRS agreed with the proposed response.

10. **Section 401(a) - Determination Letter Procedures.**

Since Form 5302 has been withdrawn from the determination letter process, to what extent will information submitted in the demonstrations contemplated by Rev. Proc. 93-39 be confidential?
PROPOSED RESPONSE. All such information required to be submitted will not be deemed confidential and will be disclosed to interested parties upon request. See Rev. Proc. 95-6, section 5.03 & section 18.07.

Reference is made to the May 1980 Memorandum to Commissioner Williams.

IRS RESPONSE. The IRS agreed with the proposed response. As Rev. Proc. 95-6 states, the submission material and demonstrations are disclosable. The 5302, the old information for high 25 employees, is not required, but if such information were required under a demo, an argument could be made that it would not be disclosable.

11. Section 401(a)(2) Exclusive Benefit Rule.
A prototype plan provides for a return of employer contributions due to mistake of fact. Employer A, sponsor of the A Company profit sharing plan, contributes 15% of presumed eligible payroll to the trustee. During administration it is determined that two (2) participants are not eligible to share in the employer contribution for that year. Employer A writes to the trustee, within one year, to request a return of the contribution due to mistaken application of the determination of eligible participants. The returned contribution is unadjusted for earnings.

PROPOSED RESPONSE. Since the employer erred in determining the proper number of participants, and since the employer would violate the terms of the plan to allocate an employer contribution to ineligible employees, and that the contribution would exceed section 404 deductible limits, the funds can be returned to the employer due to mistake of fact. The exclusive benefit rule has not been violated by the return of the mistaken employer contribution.

IRS RESPONSE. The IRS agreed with the proposed response. The IRS had trouble understanding the facts. If the plan by its terms required the contribution, then its arguable that the contribution was a mistake of fact and the contribution would be returnable. But if the contribution is not specifically required and the employer mis-estimated the contribution by including the employees, then the contribution would not be returnable. So if the plan were a discretionary profit sharing plan, the contribution would not be returnable to the employer.

12. Section 401(a)(2) Exclusive Benefit Rule.
As a follow-up to the previous question on the return of employer contributions due to mistake of fact, the Form 5500 or Form 5500-C/R, at question 9h, asks if any of the trust assets reverted to the employer. Is a return of employer contributions due to mistake of fact the type of reversion the IRS is looking for by the question? Is a “no” answer to question 9h correct?

PROPOSED RESPONSE. A return of employer contribution due to mistake of fact is not a reversion of the type that is subject to the excise tax pursuant to section 4980. A “no” answer to question 9h is correct.

IRS RESPONSE. The IRS agreed with the proposed response. If the contribution is made as a mistake of fact, a “no” is an appropriate response.

13. Section 401(a)(4) - Nondiscrimination in Plan Amendments.
Does the five year safe harbor limit on past service credits apply when a plan is set up as a result of the spin-off of a division of a corporation, and the new corporation adopts a plan granting past service credit
with the entity prior to the spin-off? Assume that the new plan receives assets from the prior plan in a section 414(l) transfer.

**PROPOSED RESPONSE.** No. As a practical matter, the plan would be required to take that service into account under section 414(a).

**IRS RESPONSE.** There is not a 5 year limit on granting past service, there is just a 5 year safe harbor. Granting more past service just requires use of the significant discrimination standard using a facts and circumstances analysis. Under these circumstances, you are probably okay, but not because of any limit on the use of past service.

14. **Section 401(a)(4) Nondiscrimination Standards.**
Is it permissible for a qualified defined contribution plan to make a distribution of plan benefits which are fixed and determined as of a specified valuation date following a participant’s termination of employment (e.g., the last day of the month in which the termination occurs), and distributed within a reasonable time thereafter, if such distribution, in a uniform and consistent manner, does not take into account any investment losses or gains that the distributable amount may have experienced during the time between the valuation date and the date of actual distribution?

**PROPOSED RESPONSE.** It appears that the Code would not prohibit the above proposed arrangement. Reg. 1.401(a)(4)-1(c)(8) provides that the allocation of earnings in a defined contribution plan will not violate the nondiscrimination requirements of section 401(a)(4) if “the manner in which income, expenses, gains, or losses are allocated to accounts under the plan [does not discriminate] in favor of HCEs or former HCEs.” The anticipated interim period (which is necessary for the processing of distributions) between valuation and actual distribution, and the protection from investment losses, would apply uniformly to HCEs and non-HCEs. Any actual earnings or losses experienced during this interim period would be allocated uniformly (i.e., without discrimination between HCEs and non-HCEs) among the remaining participants’ accounts under the plan.

**IRS RESPONSE.** The IRS agreed with the proposed response. There should not be a problem skipping crediting earnings during the gap period, as long as it is done on a consistent basis for all employees.

15. **Section 401(a)(9) - Minimum Distributions.**
Is the amount of the minimum distribution under section 401(a)(9) from an ESOP determined by reference to the number of shares or the dollar value of the shares? It would seem that the dollar value should be used, because the same scenario could occur in any type of self-directed account plan where the participant directed that all of his account balance be invested in one employer’s stock.

**PROPOSED RESPONSE.** The minimum distribution is a dollar amount, not a per share amount.

**IRS RESPONSE.** The IRS agreed with the proposed response. The minimum distribution is a dollar amount, not a share amount, although the IRS received some comments on the proposed section 401(a)(9) regulations on whether the minimum distribution could be a share amount. The IRS will consider these comments when the 401(a)(9) regulations are finalized, whenever that is done.

16. **Section 401(a)(9) - Minimum Distributions.**
Is a minimum distribution required with respect to the year in which the participant (who is age 80) dies, where he dies after the distributions have commenced, and the surviving spouse (who is under age 70) rolls it over and treats it as her own.

**PROPOSED RESPONSE.** Yes. Whether a distribution is required is determined as of December 31 of the preceding calendar year, so that subsequent events should not eliminate the need for the distribution.

**IRS RESPONSE.** The IRS agreed with the proposed response. But note the temporary regulations under 402(c) indicate the first money out of the plan is the minimum distribution amount, which doesn’t qualify for rollover. The IRS assumes only the portion allowable for rollover are so rolled over.

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17. **Section 401(a)(11) - Qualified Joint and Survivor Annuity Requirements.**

Plan X is a profit sharing plan with individual participant accounts and is not subject to the minimum funding standards of section 412. Plan X permits participant loans and the normal form of benefit is an age 65 lump sum. However the retiree can elect to defer commencement of distributions until age 70 1/2. During the deferral period, retirees can elect to have any portion of their account balance paid in cash, paid in company stock, or used to purchase a life annuity contract. Plan X generally provides the participant’s account balance is payable upon the participant’s death to the participant’s surviving spouse (unless the spouse consents to the designation of another beneficiary).

1. Does a plan loan to an active employee require spousal consent where the employee, as of the date of the loan, has never elected to have the plan purchase a life annuity contract?
2. Does a plan loan to a retiree require spousal consent where the retiree, as of the date of the loan, has never elected to have the plan purchase a life annuity contract?
3. If an active employee with an outstanding loan retires and elects to have the plan purchase a life annuity contract with a portion of his or her account balance, and subsequently defaults on the loan, must the plan obtain spousal consent to set off the loan against the employee’s remaining account balance?

**PROPOSED RESPONSE.**

1. No spousal consent is required. Reg. 1.401(a)-20 Q&A-24 provides that spousal consent is not required if the plan or the participant is not subject to the qualified survivor annuity requirements of section 401(a)(11) at the time the accrued benefit is used as security for the loan. The qualified survivor annuity requirements of section 401(a)(11) do not apply to a participant of Plan X because (a) the plan is a defined contribution plan that is not subject to the section 412 minimum funding standards, (b) the plan provides that the participant’s nonforfeitable accrued benefit (less any security interest held by the plan pertaining to an outstanding participant loan) is payable on the death of the participant to the participant’s spouse (unless the spouse consents to the designation of another beneficiary), and (c) the participant has not elected a payment in the form of a life annuity. The fact that the participant may elect a life annuity after he/she retires in the future does not require spousal consent at the time of this loan.

2. No spousal consent is required. This is consistent with the analysis presented for question one. The fact the retiree participant could have elected a life annuity prior to the loan does not require spousal consent at the time of this loan. Reg. 1.401(a)-20 Q&A-4 indicates that once a participant elects a life annuity option under a defined contribution plan, that plan will thereafter always be subject to the survivor annuity requirements of section 401(a)(11) and 417 with respect to that participant. The logical implication is that the plan remains not subject to the survivor annuity requirements of section 401(a)(11) and 417 with respect to that participant until that participant actually elects a life annuity.
3. No spousal consent is required. Reg. 1.401(a)-20 Q&A-24 provides that spousal consent is not required at the time the accrued benefits are used as security, spousal consent is not required at the time of any setoff of the loan against the accrued benefit resulting from a default.

**IRS RESPONSE.** The IRS agreed with the proposed responses. Spousal consent is not required because section 401(a)(11) generally doesn’t apply to a profit sharing plan unless the normal form of benefit is an annuity and here it is a lump sum at normal retirement age.

18. **Section 401(a)(13) - Anti-alienation Rule.**
Is the availability of the exception to the anti-alienation rule contained in reg. 1.401(a)-13(d) conditioned upon the plan containing enabling language?

**PROPOSED RESPONSE.** Yes. Paragraph (d)(1) of that regulation states that a "plan may provide" for such exceptions.

**IRS RESPONSE.** The IRS agreed with the proposed response. By the terms of the regulations, if you want to provide this it should be in the plan. But the plan terms may not have to exactly follow the terms of the regulation. Other terms allowing distribution to third parties may be sufficient.

19. **Section 401(a)(26) Minimum Participation Requirements.**
Does a retroactive merger of plans under Reg. 1.401(a)(26)-7(c) need to be considered for purposes other than satisfying the minimum participation requirements of section 401(a)(26), specifically, sections 401(a)(4), 401(k), 401(m) and 410(b), or is the merger taken into account solely for purposes of section 401(a)(26)?

**PROPOSED RESPONSE.** A retroactive merger of plans under Reg. 1.401(a)(26)-7(c) is considered a retroactive merger for purposes of sections 401(a)(4), 401(k), 401(m) and 410(b). However, the retroactively merged plans can be restructured for purposes of section 401(a)(4) nondiscrimination and section 410(b) coverage testing for the period to which the deemed merger relates, except for purpose of applying the nondiscrimination requirements of sections 401(k)(3) and 401(m)(2).

The first sentence of Reg. 1.401(a)(26)-7(c) provides that a plan may be retroactively corrected by amendment to satisfy section 401(a)(26), if such amendment is made during the same period and under the same conditions as provided for in Reg. 1.401(a)(4)-11(g)(3) through (g)(5).

The second sentence of Reg. 1.401(a)(26)-7(c) provides that a plan merger made by the end of the period provided in Reg. 1.401(a)(4)-11(g)(3)(iv) is treated solely for purposes of section 401(a)(26) as if it were effective as of the first day of the plan year.

The conditions applicable to retroactive correction under Reg. 1.401(a)(4)-11(g)(3) through (g)(5) include, among other things, a requirement that the amendment be effective for all purposes under section 401(a)(4) (Reg. 1.401(a)(4)-11(g)(3)(iii)), and section 401(b) (Reg. 1.401(a)(4)-11(g)(5)). Reg. 1.401(a)(4)-9(c) provides that a plan may be restructured into component plans for purposes of satisfying sections 401(a)(4) and 410(b) except for sections 401(k) and (m) plans.

Reading both sentences of reg. 1.401(a)(4)-7(c) together, a retroactive correction in the form of either an amendment or plan merger must satisfy the conditions applicable to retroactive correction under the section 401(a)(4) regulations. Thus, a retroactive merger will be considered as occurring on the first day
of the plan year for purposes of sections 401(a)(26), 401(a)(4) and 410(b) despite the words "solely for purposes of section 401(a)(26)" in the second sentence of reg. 1.401(a)(26)-7(c) regarding plan mergers.

In order to demonstrate compliance with sections 401(a)(4) and 410(b) by a retroactively merged plan, the plan may be restructured into component plans under reg. 1.401(a)(4)-9(c). For example, if two retroactively merged plans offered certain different rights, benefits, or features, the retroactively merged plan can be restructured into two components comprised of the two separate plans which existed prior to the merger in order to satisfy section 401(a)(4).

However, because restructuring is not available to section 401(k) and (m) plans, the retroactively merged plan must demonstrate compliance with sections 401(k) and (m) as a single plan even though sections 401(a)(4) and 410(b) compliance are being demonstrated via restructured component plans.

IRS RESPONSE. The IRS agreed with the proposed response. If the plans are merged retroactively, it would have to be considered one plan for qualification purposes. This shouldn’t be a problem for 410(b) or 401(a)(4) purposes, but could be a problem for 401(k) and 401(m) testing purposes. So if a 401(k) plan is merged with a profit sharing plan, there should not be a problem with qualification requirements, but merging two 401(k) plans would require retroactive ADP testing for the period of retroactive merger.

In response to a question, the IRS indicated the retroactive application of the 401(k) nondiscrimination test would apply for all years the plan is retroactively merged during the 401(b) remedial amendment period. The audience noted this position was contrary to other statements by other IRS officials at previous meetings.

20. Section 401(a)(28) - ESOP Diversification.
Must an individual get credited with years of participation following termination of employment (but while the individual still has an account balance in the ESOP) for purposes of section 401(a)(28).

PROPOSED RESPONSE. No. The same result should apply here that applies for purposes of determining eligibility for lump sum distribution treatment under section 402.

IRS RESPONSE. The IRS didn’t believe there was a clear answer on this, but the preference was to use a 410(b)-type analysis. However, other government officials apparently believe it is better to use a Title I of ERISA approach which would be based on 10 years of having an account balance. The IRS officials present didn’t think it was aggressive to say you had to have an allocation to have a year of participation.

21. Section 401(a)(31) - Direct Rollovers.
Can a participant transfer after-tax contributions from one plan to another via a direct rollover?

PROPOSED RESPONSE. No. Those amounts could not be transferred via a traditional rollover, and the new direct rollover should not change that result.

IRS RESPONSE. The IRS agreed with the proposed response. Only eligible rollover distribution amounts can be directly rolled over, and any amount that is not includable in income is not an eligible rollover distribution.

22. Section 401(k) Cash or Deferred Arrangement.
Under the deemed hardship distribution standards in reg. 1.401(k)-1(d)(2)(iv) (the "safe harbors"), an employee must have, among other requirements, obtained all non-hardship distributions and all non-taxable loans currently available under "all plans maintained by the employer," in order for the distribution to be deemed necessary to satisfy his immediate and heavy financial need. Another safe harbor requires that the plan or an otherwise legally enforceable agreement prohibit the employee from making contributions to the plan and "all other plans maintained by the employer" for 12 months after the distribution. The regulations go on to define "all other plans maintained by the employer" for purposes of the second safe harbor as all qualified and nonqualified plans of deferred compensation maintained by the employer. Does this definition of "all other plans maintained by the employer" apply for the first safe harbor as well?

PROPOSED RESPONSE. The term "all other plans maintained by the employer" has the same meaning for both safe harbors. The purpose of the first of these safe harbors is to insure that the employee has exhausted all other available resources of which the employer has knowledge.

IRS RESPONSE. The IRS agreed with the proposed response. The better interpretation is that the definition of "plan" as it appears in the regulations applies for both purposes, so to receive a hardship distribution the participant should receive distributions or loans from the employer's nonqualified and qualified plans.

23. Section 401(k) - Cash or Deferred Arrangement.
If the purchaser "flips" the purchased assets (i.e., sells the purchased assets to a third party) immediately, will the second purchaser be considered the "purchaser" for purposes of the requirement that the employees receiving distributions go to work for the purchaser? See reg. 1.401(k)-1(d)(4)(ii).

PROPOSED RESPONSE. Yes. The concern is that the employee not continue working for the (original) seller.

IRS RESPONSE. The IRS agreed with the proposed response. The IRS would treat where the employees end up as the proper entity for purposes of the distribution rule. If the employees have separated from the seller and they don't go follow the business, then there's no concern with the same desk rule and a distribution could be made on account of separation from service.

24. Section 401(k) Cash or Deferred Arrangements.
What is the current position of the Service with regard to the use of long-term disability benefits or severance pay (or pay received during a terminal leave of absence) as a salary reduction source for 401(k) or 125 plans?

PROPOSED RESPONSE. Salary reduction elections for section 401(k) and 125 plans cannot be applied to severance pay if the individual involved will no longer be an employee when the severance pay or disability benefits are received. The section 401(k) and 125 salary reduction election can only apply to payments received while the individual is an employee and, therefore, payments such as severance pay and disability benefits that are made after termination of employment are not eligible for the salary reduction election, even though they may be treated as compensation for other purposes. However, an individual who is on leave of absence in contemplation of dismissal is still an employee and can use LOA pay to fund salary reductions.
IRS RESPONSE. 1.401(k)-1(g)(5) requires that a cash or deferred election must be made by an employee, which is defined as someone currently performing services for the employer. Additionally, severance pay might not be permissible 415 compensation, if paid in a limitation year in which there is not an employer-employee relationship. A distinction for disability would be the special 415 rule allowing contributions under defined contribution plans for disabled participants, but that probably wouldn't follow through for 401(k) purposes. The imputed compensation and service rules would permit the consideration of such compensation for defined benefit plans, but they don't apply for purposes of defined contribution plans or for purposes of section 415.

25. Section 401(k) - Cash or Deferred Arrangements.
In testing coverage for a 401(k) plan that is in a controlled group with a governmental or tax-exempt entity, reg. 1.410(b)-6(g) provides an exception allowing employees of the governmental or tax-exempt entity to be treated as excludable employees. This exception is necessitated because section 401(k)(4)(B) currently prohibits a governmental or tax-exempt entity from adopting a 401(k) plan. However, under the regulation, this exception is only viable if “more than 95% of the employees of the employer who are not precluded from being eligible employees by section 401(k)(4)(B) benefit under the plan for the plan year.” Read literally, if the 401(k) plan has standard age and service provisions that excluded more than 5% of the non-governmental, non-tax-exempt entity employees from participating in the 401(k) plan, the 95% requirement would not be satisfied.

PROPOSED RESPONSE. The regulation should be interpreted as requiring only that 95% of the nonexcludable employees (that is, those who satisfy age and service requirements and are not precluded from being eligible due to section 401(k)(4)(B)) benefit under the plan for the plan year. This surely is the intended result; otherwise, to qualify for this exception, an employer with very modest turnover of just over 5% during the first year of employment would have to provide for almost immediate participation in order to satisfy the 95% rule.

IRS RESPONSE. The IRS agreed with the proposed response. The rules on who is an excludable employee overarch the entire 410(b) regulations, so such employees would just drop from sight for purposes of the 95% test.

26. Section 401(m) - Definition of “Eligible Employee.”
In a 401(k)/(m) plan permitting pre-tax deferrals, employee contributions and employer matching contributions, eligibility for matching contributions is restricted to participants who are employed on the last day of the plan year. However, all participants are eligible to make employee contributions. For purposes of performing the Average Contribution Percentage (“ACP”) testing, are all participants “Eligible Employees”?

PROPOSED RESPONSE. The regulations under section 401(m)-1(f)(4) provide that an “Eligible Employee” is anyone eligible to make an employee contribution OR to receive a matching contribution. The regulation further states that, if an employee must satisfy a service requirement in order to be eligible to make an employer contribution OR to receive an allocation of a matching contribution, the employee is not eligible unless such service requirement is met. These two sentences are somewhat contradictory; however, it appears that because of the prior provision, all participants who are eligible to make employee contributions should be tested under the ACP test as eligible employees (for purposes of both the employee contributions and the matching contributions), even if they do not remain employed through the last day of the plan year.
Similarly, for purposes of satisfying the minimum coverage rules of section 410(b), a 401(m) plan should be able to treat all participants as ‘eligible employees’ for purposes of satisfying the 70% ratio test under the same analysis. The regulations under reg. 1.410(b)-3 provide that an employee is treated as “benefiting” under a 401(m) plan if he is an eligible employee as defined in reg. 1.401(m)-1(f)(4).

**IRS RESPONSE.** The IRS agreed with the proposed response. As long as individuals are permitted to make after-tax contributions, they are considered participants. So employees that don’t make a contribution will count for the minimum coverage test, but will count as zeros under the 401(m) test, a sort of balancing act.

### 27. Section 404 Deduction Limit.

In computing the section 404 deduction limit, may the employer take into account compensation of employees who were eligible to make 401(k) contributions, but chose not to do so, and who did not otherwise receive any employer contribution (or forfeiture, for that matter) under the plan?

**PROPOSED RESPONSE.** Section 404(a)(3)(A)(i) limits the contribution deduction for profit-sharing plans to “15 percent of the compensation otherwise paid or accrued during the taxable year to beneficiaries under the plan.” Reg. 1.404(a)-9(b)(i) provides that “the limitation shall be based on the compensation during the taxable year to the employees who, in such taxable year of the employer, are beneficiaries of the trust funds accumulated under the plan.”

The IRS explained its understanding of these provisions of the Code and regulations in Rev. Rul. 65-295, 1965-2 CB 148 as they apply to a profit-sharing plan that includes a “last day” rule. Under such a plan, only the employees who are still employed by the employer on the last day of the plan year are entitled to share in the employer contribution for the plan year. The IRS concluded that the “employees” referred to in the Code and regulations are “those employees who participate in the allocation of the employer’s contribution to the plan in the year for which such contribution is made.” Therefore, if an employee terminates his employment before year end and is ineligible to share in the allocation of the employer contribution for the year, the employee’s compensation cannot be considered under the plan for that year for the purpose of computing the deduction limitation.

The Internal Revenue Service’s reasoning was carried one step further in *Dallas Dental Lab, Inc.*, 72 TC No. 10, ¶ 72.10 P-H TC (1979). The Dallas Dental Lab, Inc. Profit Sharing Plan for Employees did not include a last day rule. All employees were immediately eligible to participate in the Plan and were entitled to receive a share of the employer contribution for the year based on their compensation for the year. However, the accounts of nonvested terminated employees were forfeited after the end of the plan year after the contribution for the year was allocated to their accounts. Thus, an employee might receive a contribution allocation that would be immediately forfeited. The Internal Revenue Service contended, and the Tax Court agreed, that the compensation of these employees should not be considered in determining the 15 percent deduction limit because “it was clear that they would never derive any benefit from any allocation that might be made to their accounts.” *Dallas Dental Lab, Inc.* involved the 1972-74 tax years. Although ERISA’s cash-out/buy-back rules might make the result in this case different today, because an employee whose account is forfeited at the end of the year in which he terminates would have to be reinstated if he returned to work before incurring five consecutive one-year breaks in service, the case makes clear that an actual, meaningful allocation is required in order for an employee’s compensation to be includable in determining the 15 percent deduction limit.

Following the logic of Rev. Rul. 65-295 and *Dallas Dental Lab, Inc.*, the compensation of an employee who is eligible to make 401(k) contributions, but chooses not to do so, would not be includable as employee compensation for the purpose of determining the deduction limit (assuming that the employee
does not receive any other employer contribution under the plan, such as a nonelective employer contribution).

A contrary argument could be based on the plan qualification regulations. Reg. 1.410(b) requires that certain coverage tests be satisfied with respect to employees who "benefit" under the plan. Reg. 1.410(b)-3(a)(2)(i) provides that an employee is "treated as benefiting" under a 401(k) plan if and only if the employee is eligible to make salary reduction contributions to the plan for all or a portion of the plan year. Similarly, the actual deferral percentage test applicable to a 401(k) plan is based on the deferral ratios of all eligible employees. An eligible employee who does not elect to make any 401(k) contributions during a year has a "zero" deferral ratio. The argument would be that if an employee is treated as benefiting for the purposes of section 410(b) and is included in deferral percentage testing, then the employee must be treated as benefiting for the purpose of computing the deduction limit under section 404.

IRS RESPONSE. In a 401(k) plan, someone is counted as benefiting regardless of whether they make an elective deferral. The 410(b) rules flow through for purposes of 404, so such employees compensation can be considered even though they receive no actual benefits.

28. Section 408 Individual Retirement Accounts.
Rev. Proc. 87-50, for opinion letters and amendments to IRAs, describes in some detail the procedures that are to be followed. In the course of working with transactions involving IRAs, the following questions that are not addressed in the revenue procedure appear with some frequency:

(a) If the custodian under an IRA document on which an IRS opinion letter has been issued amends the document to substitute the provisions of Form 5305 or 5305A, for which no opinion letter is required, is the custodian required to notify the IRS? Presumably, the custodian is required to notify each IRA depositor because the custodian would be required to send copies of the amended IRA document to each IRA depositor.

(b) A custodian amends an IRA on which an opinion letter has been issued and substitutes Form 5305 or 5305A. Is the custodian required to obtain an executed Form 5305 or 5305A from each of its customers who had executed an adoption agreement for the amended IRA, or is it enough to send the Form 5305 or 5305A to each such customer?

(c) If an IRA sponsor is authorized by the IRA document to remove the custodian and appoint a new custodian, may the appointment be automatic upon notice to the IRA depositors?

(d) If the sponsor of an IRA amends and restates the IRA to substitute Form 5305 or 5305A, and the sponsor removes and replaces the custodian with a new custodian that is the sponsor of IRAs on the identical Form 5305 or 5305A documents, are the IRA customers automatically treated as maintaining their IRAs on the IRA document of the new custodian once they are notified of the change in custodians? Must the IRA customers be offered the opportunity to refuse to be treated as maintaining their IRAs on the IRA documents of the new custodian? Are the IRAs transferred to the new custodian treated as maintained on the IRA documents of the new custodian only if the customer executes the new custodian's Form 5305 or 5305A?

PROPOSED RESPONSE.
(a) Yes.
(b) Sending a copy of the Form 5305 or 5305A is enough.

regs. 1.401(k)-19b)(2) and 1.401(k)-1(g)(4).
Yes. An IRA customer always has the option to remove an IRA custodian or withdraw funds and move funds to another IRA.
Yes, yes, and re-execution is not required.

IRS RESPONSE. In Announcement 93-8, which provided guidance on how IRA owners could amend their documents to comply with 401(a)(9), the IRS implied certain positions. There is no need for employees to execute the documents anew.
(a) The IRS agreed with the proposed response.
(b) The IRS agreed with the proposed response.
(c) The IRS agreed with the proposed response.
(d) The IRS agreed with the first answer, disagreed with the second answer, and agreed with the third answer.

29. Section 410(b) Average Benefit Percentage Test.
A defined contribution plan has a service requirement of one year for eligibility and a defined benefit plan allows immediate participation. For purposes of performing the average benefit percentage test, are the plans deemed permissively aggregated for purposes of determining the nonexcludable employees?

PROPOSED RESPONSE. Both plans are in the testing group, so both plans must be taken into account in determining an employee’s employee benefit percentage. Reg. 1.410(b)-6 provides that excludable employees are determined separately with respect to each plan. Presumably the plans are treated as aggregated, so that only those employees who fail all of the different sets of age and service conditions are excludable employees for purposes of the average benefit percentage test.

IRS RESPONSE. The IRS agreed with the proposed response. The rules that apply for this form of aggregation for the average benefits percentage test are the same rules that apply for any other kind of aggregation and so under this set of facts everyone would be taken into account under the average benefits percentage test.

30. Section 411(a) Normal Retirement Age.
Defined Benefit Plan 1, which has an age 60 normal retirement age, is merging into Defined Benefit Plan 2, which has an age 65 normal retirement age. Assuming the Plan 1 NRA must be preserved with respect to benefits accrued by the date of the merger, can the merged plan require retiring participants to take their full benefit at one time? What features of the Plan 1 NRA must be preserved?

PROPOSED RESPONSE. If the definition of NRA is viewed as a vesting rule rather than a distribution option, this problem can be resolved relatively simply. The plan could treat age 65 as NRA, allow early retirement at age 60, and provide that the whole benefit must be claimed at one time. Someone with a split-level benefit who takes early retirement would have no reduction in the benefit earned under Plan 1, but there could be an actuarial reduction in the Plan 2 piece. Or, if the person retired at age 65, the Plan 1 piece would be actuarially increased unless properly suspended, and the Plan 2 piece would be unreduced. Alternatively, the two benefits could be blended through a wear-away provision that provided the greater of the Plan 1 benefit payable unreduced at age 60 or the total benefit, not payable unreduced until age 65.

If, however, the fact that benefits are payable at NRA is viewed as a protected right under section 411(d)(6), the plan could not restrict participants’ right to take their benefits accrued under Plan 1 at age 60, and section 411(a)(11), as interpreted in reg. 411(a)-(11)(c)(5), would give them the right to wait until age 65 to claim the remainder of their benefit. If there are two annuity starting dates, within the meaning
of reg. 1.401(a)-20, Q&A 10(d)(2), the person could elect different payment forms for each part of the benefit. Also, employees presumably could receive in-service distributions of their Plan 1 benefits at the age-60 NRA that applies to those benefits, even though they are still working and the payout would be made from a plan that specifies an age-65 NRA.

It would obviously be most desirable if IRS could take the position that all that is required is preservation of the age-60 nonforfeitality of the Plan 1 benefit.

**IRS RESPONSE.** The IRS indicated the normal retirement age is not simply a vesting issue, and 411(d)(6) requires the ability of participants to receive benefits at the earlier retirement age must be protected. This requires complex administrative problems dealing with the fact that are two different parts of the benefit that must be paid at different times, and this affects the REA annuity starting date of the different portions of the benefit.

31. **Section 411(a)(7) - Cashout of Accrued Benefit.**
Suppose that a participant only makes a partial repayment. Can the plan refuse to restore any portion of the benefit that was forfeited?

**PROPOSED RESPONSE.** Yes. Reg. 1.411(a)-7(d)(4)(iv) expressly conditions restoration upon the employee repaying "the full amount of the distribution."

**IRS RESPONSE.** The IRS agreed with the proposed response. There is no right to a restoration of benefit unless the participant repays the entire cashed out amount. The plan can be more generous, but they can also insist upon the full cash out amount.

32. **Section 411(d)(6) - Cutback of Benefits.**
A profit-sharing plan provides for hardship distribution of employer contributions. The standards for hardship are more lenient than the standards typically imposed on a Plan subject to section 401(k) by reg. 1.401(k)-1(d)(1)(iv). The employer desires to amend the Plan to remove the provision for hardship distribution.

Q&A 1(d) of Reg. 1.411(d)-4 lists examples of benefits that are not protected benefits. The list of non-protected benefits does not include hardship benefits. However, Q&A 2(b)(2)(x) of reg. 1.411(d)-4 states that a CODA may eliminate a hardship provision. Is a hardship provision a protected benefit in a profit sharing plan that is not a CODA?

**PROPOSED RESPONSE.** A provision in any type of profit-sharing plan for a hardship distribution is not a protected benefit under section 411(d)(6). The provision in Q&A 2(b)(2)(x) of reg. 1.411(d)-4 was added by TD 8357 which modified regulations dealing with CODAs. As a result, the list in Q&A 1(d) of the regulations was not modified while paragraph (x) was added to Q&A 2(b)(2) for clarification of the extent of protection to be given to hardship provisions in CODAs. Inasmuch as a CODA (with few exceptions) is a profit-sharing plan, it is proper to conclude that any profit-sharing plan, whether or not a CODA, may eliminate a hardship provision without violating the accrued benefit rules.

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This in itself is a conundrum. The regulation essentially seems to say that plans can require that the benefit form elected upon retirement on or after normal retirement age governs the payment of any additional benefits earned after that, but if retirement is before NRA a new benefit election is required with respect to subsequent accruals. In the situation described here, the person would be retiring on one NRA but before the other.
IRS RESPONSE. The IRS agreed with the proposed response. The final 401(k) regulations permitted plans to eliminate hardship distributions or make them more restrictive, a position that was extended to all profit sharing plans.

33. Section 411(d)(6) - Cutback of Benefits.
A profit sharing thrift plan providing for after tax employee contributions permits hardship distributions to be made of employer matching contributions. Hardship standards are more lenient than those imposed by reg. 1.401(k)-1(d)(iv). The thrift plan merges into a CODA. Must the value of employer matching contributions up to the date of merger be subject to hardship distribution on the basis of pre-merger rules? May the vestigial hardship distribution rules applying to pre-merger matching money be eliminated?

PROPOSED RESPONSE. Q&A 2(b)(2)(x) of reg. 1.411(d)-4 permits a hardship distribution rule to be eliminated from a CODA. However, the hardship distribution in the former thrift plan may be a protected benefit under Q&A 1(d) of reg. 1.411(d)-4 and may not be subject to elimination after merger.

The provision for the hardship distribution could have been eliminated from the thrift plan before the merger of the plans. Hence, the provision is not protected from elimination after the merger. It is not within the intent of Q&A 2(b)(2)(x) that the rule permitting elimination of a hardship distribution provision be confined to a CODA.

IRS RESPONSE. The IRS agreed with the proposed response. See the prior answer.

34. Section 411(d)(6) - Cutback of Benefits.
Plan X is a union negotiated defined benefit plan. Plan X provides for a $5000 death benefit on the death of a Participant retiring after normal, early, or disability retirement or on death after entering pay status. The death benefit is not funded by insurance but is self insured. The Board proposes to amend the Plan to eliminate the death benefit. The active members of the union and the contributing employers vote for the amendment. Neither retired participants nor vested participants with benefits not in pay status vote on the change. Is the death benefit proposed to be eliminated a protected benefit under section 411(d)(6)?

PROPOSED RESPONSE. Q&A 1(d) of reg. 1.411(d)-4 sets out a list of benefits that are not section 411(d)(6) protected benefits. Included in the list of non-protected benefits is auxiliary life insurance protection. As used in the regulation, "auxiliary life insurance protection" is not intended to have a meaning restricted to death benefit protection provided by conventional life insurance products. The term is intended to include self funded arrangements for death benefits that are auxiliary to the pension benefit being provided in cases described in the facts given. In the example presented, the death benefit is auxiliary and is not a benefit protected by section 411(d)(6).

IRS RESPONSE. The IRS agreed with the proposed response. It doesn’t matter whether a death benefit is self-insured or not, it is still an ancillary death benefit and not 411(d)(6) protected.

35. Section 412 Annual Valuation.
IRS Announcement 94-101 referenced Rev. Rul. 80-155 in stating that annual valuation of plan assets is required. The announcement seems to suggest that the concern is not discrimination against non-highly compensated participants. Do the valuation requirements mandate annual asset valuations for any plan asset even those held in segregated accounts? Do the same rules apply to assets held in Individual Retirement Accounts?
PROPOSED RESPONSE. Although the concern of Announcement 94-101 and Rev. Rul. 80-155 was determining the proper allocation of earnings among all participants during each plan year, assets must be valued every year to properly report on Form 5500, Form 5500-C/R, and the Summary Annual Report. Of particular concern is the valuation of assets during a plan year in which a distribution is made regardless of it being distributed from a qualified plan segregated account or an individual retirement account. Assets in segregated accounts of qualified plans cannot be left unappraised until distribution but must be valued on an annual basis along with all qualified plan assets. The audit guidelines, at 350 Valuation of Assets section 351(3)(a) recites that such assets may be less formally appraised. The reasonableness of the method will be judged on a facts and circumstances basis.

IRS RESPONSE. The IRS agreed with the proposed response. An individual account plan has to value assets annually, even when that doesn’t really have an affect on any participant’s benefit. However, in certain circumstances, there may be some slack in what is an appropriate valuation. In situations where there are not allocations to employees and individual directions of investments, for example, independent appraisals may not be necessary.

36. Section 414(q) Highly Compensated Employees.
Some employers want to exclude highly compensated employees from participation in 401(k) plans. In part, this is done to avoid the need for discrimination testing. Generally, use of the look-back year calculation allows employers to know which employees must excluded as HCE’s before the start of the plan year. However, it sometimes happens that late in a determination year a NHCE receives an unexpected, substantial commission or bonus so as to place him within the top-100 group. If a plan by its terms excludes HCE’s, can such a “springing” HCE be retroactively excluded from participation for the plan year?

PROPOSED RESPONSE. Yes. Since the plan’s eligibility provision has always excluded HCEs, the individual who jumps from NHCE to top-100 status during a determination year is not eligible for the whole year, elective deferrals were thus accepted in error and should be refunded.

IRS RESPONSE. The IRS noted the preamble to the original version of the final nondiscrimination regulations indicated that:

...the Treasury and the Service recognize that in some situations, unique problems related to a merger or acquisition may make exact adherence to some of the provisions of the regulations impossible. For example, it may be difficult to obtain prior year data necessary for determining with certainty whether certain acquired employees are highly compensated employees. Pending issuance of further guidance, in limited situations, in the context of a merger or acquisition, a reasonable good faith effort to satisfy the nondiscrimination requirements consistent with statutory and regulatory requirements will be acceptable.

37. Section 415 - Increase in Limit for Late Retirement.
Rev. Rul. 95-29, Q&A 8 indicates that “if the age at which the benefit is payable is greater than the participant’s SSRA, the dollar limitation is increased so that the limitation is actuarially equivalent to the limitation at the participant’s SSRA. In general, Subsection 415(b)(2)(E)(i) and (v) require that the increased dollar limitation is the lesser of the equivalent amount computed using the interest rate and mortality table (or other tabular factor) used for actuarial equivalence for late retirement benefits under the plan and the amount computed using 5 percent interest and the applicable mortality table."

Does this mean that an adjustment of the 415 dollar limit is not permitted if the plan does not actuarially increase benefits for late retirement but instead issues the suspension of benefits notice? If so, for late retirees who take lump sums, and the 415 dollar limits are not increased, would the decrease in lump sum
values just be part of the benefits lost due to continued employment (after issuance of the suspension of benefits notice)?

**PROPOSED RESPONSE.** Section 415(b)(2)(E)(i) indicates the interest rate should be "not less than the greater of 5 percent or the rate specified in the plan." There is no mention of what use the rate has to be used for. If the plan doesn't make actuarial adjustments for late retirement, but does specify another rate for making actuarial adjustment between different benefit options, that rate should be acceptable for increasing the section 415 limit for late retirees.

**IRS RESPONSE.** The IRS disagreed with the proposed response. The IRS indicated the rate used for increasing benefits for late retirement under the plan was the rate that had to be used for increasing the 415 limit for late retirement. The reference to "plan interest rate" refers to the plan interest rate used for a comparable adjustment. This position is consistent with Notice 83-10.

**38. Section 3402 Income Tax Withholding.**
Recently issued proposed regulations under section 83(h) purport to remove the requirement that, in order to deduct under section 162 the amount included in the employee's gross income under section 83, an employer transferring property to an employee in exchange for the performance of services withhold federal income tax in accordance with section 3402 in respect of that property. Does section 3402 itself, however, still require an employer to withhold federal income tax on the transferred property?

**PROPOSED RESPONSE.** Section 3402 still indicates an employer to withhold federal income taxes on property transferred to an employee in connection with the performance of services. The preamble to the proposed section 83(h) regulations states that although the withholding requirement would be eliminated as a prerequisite for claiming a deduction, the proposed amendments would not relieve the service recipient from any applicable withholding requirements of subtitle C or from the statutorily prescribed penalties or additions to tax for noncompliance with those requirements. Although employers still are liable for withholding tax under section 3402(d) and any tax liability assessed against the employer would be offset by any tax paid by the employee under section 3402(d).

**IRS RESPONSE.** The IRS agreed with the proposed response. The IRS and Treasury believe there is nothing they can do because of the statutory withholding requirement, but noted the penalties for noncompliance are not onerous because a credit is generated when the employee pays the tax.

**39. Section 4972 Nondeductible Contribution Excise Tax.**
Section 4972 imposes a 10% excise tax on nondeductible contributions to qualified plans. If a fiduciary breach or prohibited transaction is corrected by a payment to the plan of the amount of the loss realized by the plan, is the payment a contribution for purposes of section 4972?

**PROPOSED RESPONSE.** Unless the transaction were a sham, the IRS would not treat a payment made to correct a fiduciary breach as a nondeductible contribution under section 4972.

**IRS RESPONSE.** The IRS agreed with the proposed response. The IRS has released a private letter ruling, PLR 9507030, concurring with the position, as long as the payment is in settlement of a legitimate claim and the payment is intended to make the plan whole for some past error. While you don't have to wait until the parties end up in court, its a factual question regarding when such a contribution can be made based on the existence of a bona fide conflict. The IRS will consider future private letter rulings on this issue.
40. Section 4975 - Prohibited Transactions.
Assume that an Owner-Employee of an S Corporation takes out a loan, making it a prohibited transaction. The interest paid on that loan is allocated solely to his account. Assume that later, the corporation converts to C Corporation status. Does that action constitute a correction of the prohibited transaction, effecting a prospective cessation of the accrual of the excise tax?

PROPOSED RESPONSE. Yes. Requiring repayment would be useless, because the participant could obtain another loan immediately (assuming compliance with section 72(p)).

IRS RESPONSE. The IRS disagreed with the proposed response. Contrary to some judicial precedent, the IRS would not view this as correction since the loan was prohibited when made. The loan arguably would not be a continuing prohibited transaction after conversion, but correction would require repayment of the loan.

41. Section 4980A - Excise Tax on Excess Distributions.
Assume that a participant dies before the effective date of the 1986 Tax Reform Act and the surviving spouse rolls over the benefit to an IRA. Does that exempt the subsequent distributions from the IRA from the 4980A tax?

PROPOSED RESPONSE. Yes. See reg. 54.4981-1T, Q&A d-10.

IRS RESPONSE. The 4980A tax generally doesn’t apply to beneficiaries unless the spouse specifically elects to have it apply. The tax may apply if the IRA is co-mingled with the spouse’s own IRA.

42. Section 4980B Continuation Coverage.
Proposed reg. 1.162-26 Q&A 5, indicates that COBRA covers employers who are controlled group members under sections 414(b) and (c), and affiliated service groups under section 414(m) or other similar arrangements under section 414(o) and any successor of an employer or such an entity. However, this regulation does not define what constitutes a successor of an employer or entity. Does the concept of successor extend only to stock purchases or would it also extend to asset purchases?

PROPOSED RESPONSE. Because the concept of the employer is based on the controlled group provisions under section 414(b) and (c), this liability should not extend to entities acquired via asset purchases. Thus, an asset purchase of one employer which results in the seller’s health plan termination would not entitle the seller’s former employees to COBRA rights under the buyer’s health plan.

IRS RESPONSE. The IRS disagreed with the proposed response. The COBRA continuation coverage requirements apply to purchasers of businesses regardless of whether the deal is structured as a stock deal or an asset deal.

43. Section 4980B - Health Plan Continuation Coverage.
Assume that an employer’s health plan uses the calendar year for purposes of determining the amount that is charges for COBRA continuation coverage. Assume further that the insurer increases the amount of the premium on July 1. Can the employer pass the increased cost onto COBRA participants if it does the same for active employees, despite the language in Question and Answer 45 of Proposed reg. 1.162-26 that requires that the applicable premium be fixed for a period of at least 12 months? Note that the position in Question and Answer 45 is logically inconsistent with that of Question and Answer 22, which requires
that the coverage for COBRA participants and active employees must generally be the same. In this case, the COBRA participants become entitled to a subsidy, as opposed to the active employees.

PROPOSED RESPONSE. Yes. The employer should be allowed to change the amount of the premium, because COBRA participants must be treated the same as active participants.

IRS RESPONSE. The IRS disagreed with the proposed response. Q&A 45 does not permit increases in the applicable premium after the beginning of the applicable determination period. Q&A 22 is not inconsistent with this rule, nor is Q&A 23, which refers to the coverage made available to qualified beneficiaries and not to the amount the employer or plan may charge for that coverage.

44. Section 4980B - Continuation Coverage.
In a multiple employer group health plan maintained pursuant to a MEWA, must the plan provide COBRA coverage for employees of a participating employer which ceases all business operations, terminates its employees and withdraws from the plan (assuming the employer is unaffiliated with any other company), or is the participating employer responsible for the COBRA coverage? If the former, participants will receive COBRA coverage even though the employer ceases all operations, but if the latter, because the employer terminates all health coverage for employees and is not affiliated with other companies, it is not obligated to provide COBRA coverage.

PROPOSED RESPONSE. In a MEWA arrangement, in contract to a multiemployer plan, each employer, not the group health plan, is the party responsible for providing COBRA coverage upon withdrawal from the MEWA arrangement. Furthermore, if the employer ceases all business operations and no longer provides coverage to any active employees, it would not have to provide COBRA coverage to terminated employees.

IRS RESPONSE. The emphasis is whether there is any COBRA right, not whether the plan must provide coverage. In a MEWA, the employer is primarily responsible for making COBRA coverage available to qualified beneficiaries. Under paragraph E-1 and E-2 the MEWA can be held liable for not making COBRA coverage available, just as an insurance company can. Note however, that withdrawal from a MEWA is not a COBRA qualifying event. If an employer withdrawing from a MEWA ceases to provide health coverage to employees, then its COBRA obligation ceases also.

45. Section 4980B - Continuation Coverage.
An employer, which in the previous calendar year normally employed 20 or more employees, is required to provide COBRA coverage. How does this rule apply to a new employer? Are all new employers exempt from COBRA for one year?

PROPOSED RESPONSE. If a newly formed employer normally employs twenty or more employees during the current calendar year and provides group health benefits to its employees, it must provide COBRA coverage in the initial year of operation.

IRS RESPONSE. The IRS disagreed with the proposed response. No COBRA obligation exists during the first year of existence, but this applies only to genuinely new employers and not employers that have some sort of predecessor employer.

46. Section 6059 Annual Reporting.
Does a Form 5500 have to be filed with respect to a retirement plan that is solely invested in employer stock, if the value of that stock has become worthless?
PROPOSED RESPONSE. Yes. As long as there are any assets held in the plan, a Form 5500 is required.

IRS RESPONSE. The IRS agreed with the proposed response. As long as the plan is still in existence and has assets, an annual return must be filed.

47. Section 7476 Notice to Interested Parties.
Is a notice to interested parties no longer required to be given after January 1 1995, with respect to the adoption of plan amendments for which no IRS determination letter is required, such as IRS model amendments to make changes required by Code amendments or adoption of M & P plans?

Is such notice required if the employer action was done in 1994 but the time for a notice to interested party did not elapse until after the January 1, 1995 effective date of Rev. Proc. 95-6?

PROPOSED RESPONSE. Rev. Proc. 95-6 no longer seems to require a notice to interested parties where the plan is not to be submitted to the IRS for a determination letter. This is a change from Rev. Proc. 94-6. The effective date of the Rev. Proc. is January 1, 1995. No good reason would seem to exist to require plans to post such a notice because they were amended in late 1994 because of being a calendar year plan rather than after 1995 in case of fiscal year plans. Further, the notice to interested party seems to be only an IRS prerequisite to jurisdiction to issue determination letters.

IRS RESPONSE. The IRS agreed with the proposed response. Rev. Proc. 95-6 changed the notice to interested parties for plan amendments that are not filed with the IRS. So adoption of a model amendment does not require a notice to interested parties. The IRS has already agreed to the qualified nature of the amendment, and would be unlikely to change that position because of a comment from an interested party.