

ABA Sections of Business Law,
Labor Law, Real Property, Probate and Trust Law,
Taxation, and Tort and Insurance Practice

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Internal Revenue Service Questions and Answers

1. §72 Taxation of Benefits

Assume that a plan allows participants to elect to buy and sell amounts in employer stock. What effect on the basis occurs when the shares are transferred from one participant's account to another's by means of an intra-plan sale?

Proposed Answer. Although reallocation of forfeitures does not affect the plan's basis, there is a different result from purchases. The plan should use the fair market value of the stock as the (new) participant's basis, whether the shares are purchased from another participant's account or outside of the plan.

IRS Response. Appreciation is normally determined as the excess of fair market value over cost. Rev. Rul. 55-354 indicates that notwithstanding that stock has been held in the trust from the original allocation, it receives a stepped up basis upon the exchange to the new participant. The net unrealized appreciation of the stock of the new participant will be based on the fair market value of the stock upon the transfer to that participant.

2. P.S. 58 Costs

Assume an employee pays the PS 58 costs under a tax-qualified retirement plan, but the participant does not receive a distribution of the policy. Are the amount of those employee contributions received tax-free anyway?

Proposed Answer. Yes. See G.C.M. 38261 (January 31, 1980).

IRS Response. The IRS agrees with its G.C.M. The participant can recover the basis generated by the P.S. 58 costs, regardless of the form of distribution.

3. §162(m) Deduction Limits for Executive Compensation

Assume that an individual is employed by Corporation X as its CEO, and was granted a stock option to purchase stock at its fair market value. Subsequently, after there has been some appreciation in its stock, Corporation X is purchased by Corporation Y. The individual will be a covered employee of Corporation Y for purposes of § 162(m). Can Corporation Y grant the individual a replacement stock option that preserves the built-in gain in the option that was granted to the individual by Corporation X?

Proposed Answer. Yes. This is not the situation that the regulations were aimed at preventing (which is built-in gain). All that is happening here is that the executive spread at the time of the purchase is preserved.

IRS Response. The regulations do not permit the target to be adjusted, even if the original target is no longer obtainable.

4. §401(a) Determination Letters

The IRS has been taking the position in determination letter reviews (Cincinnati Key District) that a qualified plan which excludes by its terms temporary, contingent or student employees as a category violates the minimum service rules of §410(a), referencing Reg. §1.410(a)-3(e)(2)(Ex. 3). Assume a plan would pass §410(b) excluding these employees. What is the IRS rationale for this position? There are substantive differences between temporaries, contingents and student employees and an employer's regular employees, often related to salary levels, other benefits, discipline and other aspects of employment. These distinctions are not based on length of service alone. If the temporary employees are obtained from an outside temporary service agency, can they permissibly be excluded on this basis without violating §410(a) (presuming the temps would otherwise be treated as common law employees of the plan sponsor)? The IRS interpretation unduly penalizes employers which do not impose minimum service conditions in their plans.

Proposed Answer: None.

IRS Response. If plan eligibility provisions are used to exclude employees based on service criteria other than the ERISA minimums, such as part-time and seasonal, the IRS will challenge. If other employee categories are used, agents should look through the category to see if it is predominantly short service, the minimum service rule should be used. This is an issue the IRS has not been looking for until last year, and they will recognize determination letters on plans that have such exclusions, but will request a change in the plan terms prospectively.

5. §401(a)(4) Nondiscrimination Requirements

Assume that a privately-held employer wishes to allow its employees to use their funds in its profit sharing plan to purchase the employer's stock. Assume further, that because of applicable securities laws restrictions, stock cannot be offered to all employees; it must be limited to a select group of management. If the employer stock investment option is limited solely to the extent necessary to comply with applicable securities laws, would that violate §401(a)(4)?

Proposed Answer. No. If the limitation upon investors is imposed by federal or state securities laws, then observing those rules should not be considered to cause impermissible discrimination under §401(a)(4).

IRS Response. The IRS considered whether there should be an exclusion from the nondiscrimination regulations when the regulations were being drafted. The regulations do not contain such an exclusion because the it is not always clear that there is no other way to comply with the other law. The regulations do contain exemptions for 401(a)(28) and 401(n), but not a general exemption for other laws. To the extent there other examples, the IRS is willing to consider them.

6. §401(a)(4) Nondiscrimination Requirements

Assume an employer with highly compensated and non-highly compensated employees adopts a plan amendment with the following characteristics:

- It does not deal with prior service credit.
- It benefits only highly compensated active employees (HCEs).
- The HCEs benefited are selected by the employer. That is, the group of HCEs benefiting do not exist because of a Code limitation or a permissible disparity, or a merger or acquisition.
- With respect to timing of the amendment, there is no other time when the plan amendment would have benefited any non- HCEs.

(For example, amending the plan to include in the plan's definition of compensation for determining employer contributions or benefit accrual, nonqualified deferred compensation amounts where only certain high level employees are permitted to make such compensation deferrals.)

Is the plan amendment automatically discriminatory where the plan, after the amendment, satisfies the applicable amounts test under § 1.401 (a)(4)-2 or 3?

Proposed Response: The amendment does not appear to violate §1.401(a)(4)-5, because any problem with this amendment is not due to the timing of the amendment. There is no point in time when this amendment would have benefited non-HCEs. Because the amendment directly affects the amount of benefit used in the amounts test and does not otherwise create a separately identifiable right or feature, some would argue that §1.401(a)(4)-4 is not applicable to the plan amendment. Therefore, the amendment IS NOT automatically discriminatory.

On the other hand, others argue the amendment should be tested as an "other right or feature" and is thus automatically discriminatory under §1.401(a)(4)-4, because it is available only to HCEs.

Therefore, the amendment IS automatically discriminatory.

IRS Response. The IRS agreed with the proposed answer concerning the example amendment. The timing of the example amendment would not be discriminatory because the nonhighly compensated employees would never have compensation affected by the amendment. The IRS did not intend the benefits, rights, and features regulations to cover this situation. The elements of the benefit formula are not tested under the benefits, rights, and features regulations.

7. §401(a)(17) Compensation Limit

For purposes of determining compensation under §415(c) for the 25% limitation, only compensation under the §401(a)(17) limit may be taken into account. However, there are no regulations or other authority of which we are aware which state ordering rules for applying the §402(g) limitation and the §401(a)(17) limitation. If, for example, an employee receives compensation of \$200,000 in 1995, is his compensation for §415(c) purposes \$150,000 or \$140,760 (\$150,000 - \$9,240)?

Proposed Answer: Such employee's §415(c) compensation should be \$150,000, based on a reasonable reading of §402(g), which appears to operate only to limit the value of elective deferrals, and not compensation for all purposes. Also, the definitions of compensation in the regulations under §415(c) all appear to exclude by definition amounts excludable from gross income, and elective deferrals less than the §402(g) limit are so excluded.

IRS Response. The definition of 415(c) compensation is earned income, net of deductions including plan contributions. But the limit many plans are faced by is the plan terms, as demonstrated by Example (4) of 1.401(a)(17)-1(b)(6), where the plan definition of compensation for self-employed individuals determines compensation before taking into account the 404 deduction. Benefits taken into account cannot be based on comp in excess of \$ 150,000, but the limit

on benefits, which can be considered a benefit formula, is not limited by 401(a)(17). The elective deferral under a 401(k) plan does not necessarily have to reduce the compensation that can be taken into account for benefit calculation purposes. Alternatively, if the participant is beyond Social

8. §401(a)(26) Minimum Participation Standards

The scope of the retroactive correction of a failure to satisfy minimum participation rules under §401(a)(26) for a plan year under Reg. § 1.401(a)(26)-7(c) is unclear. Assume that the employer is a member of a controlled group and for the 1995 plan year, coverage under its §401(k) plan drops to fewer than 50 employees. It no longer satisfies the minimum participation requirements of §401(a)(26) for the 1995 year. On a retroactive basis, no later than October 15, 1996, the plan may either (i) be amended to expand coverage and eligibility for the 1995 plan year; or (ii) be merged with another plan maintained by a member of the controlled group.

Clearly, if the plan is amended on a retroactive basis, associated increases in allocations or accruals would be required for the 1995 plan year. However, it is not clear under the regulation whether (i) associated benefit increases provided under the merged plan for the 1995 year would be required on a retroactive basis; or (ii) §401(k) and (m) nondiscrimination testing would be required to consider participation by the merged plan participants on a retroactive basis. The regulation provides:

A plan merger that occurs by the end of the period provided in § 1.401(a)(4)-11(g)(3)(iv) is treated solely for purposes of §401(a)(26) as if it were effective as of the first day of the plan year.

The phrase suggests that the retroactive merger is effective solely to satisfy the minimum participation requirements, but need not be effective for any other purposes.

Proposed Answer:

Additional accruals or allocations must be provided to participants consistent with the provisions of the merged plan on a retroactive basis to the effective date of the plan merger. This is consistent with the requirements that would apply to a plan amendment on a retroactive basis in accordance with Reg. § 1.401(a)(4)-1 l(g)(3)(iii). The §401(k) and (m) non-discrimination tests must be recalculated for the 1995 plan year to consider participation by the merged plan participants.

IRS Response. The IRS disagrees with the proposed answer. The retroactive merger is effective only for 401 (a)(26) and the plan does not have to go back and be tested as if they were one plan for the nondiscrimination regulations

9. §401(a)(26) and 410 - Minimum Participation Requirements

Reg. §1.401(a)(26)-1(b)(4) states that a §401(k) plan may be treated as a separate plan that satisfies §401(a)(26) for a plan year if the plan is maintained by an employer who has employees precluded from being eligible employees under the plan by reason of §401 (k)(4)(B) and more than 95% of the employees who are not precluded from being eligible employees by reason of §401(k)(4)(B) benefit under the plan. §401(k)(4)(B) precludes governmental entities and tax-exempt organizations from maintaining 401(k) plans. Reg. § 1.410(b)-6(g) sets forth an identical exception to the minimum participation requirements of §410.

For purposes of the requirement that 95% of the employees who are not precluded from being eligible employees by §401 (k)(4)(B) must benefit under the 401(k) plan, are all such employees of the employer taken into account or may employees who can normally be excluded under Treas. Reg. § 1.401 (a)(26)-6 (e.g., those who do not meet minimum age and service requirements) be disregarded?

Proposed Answer: Employees who can normally be excluded under Treas. Reg. § 1.401(a)(26)-6 may be disregarded for purposes of the 95% requirement.

IRS Response. The IRS agrees with the proposed answer.

10. §401(a)(26) and 410 Minimum Participation Requirements

Do these exceptions to the §401 (a)(26) and §410 minimum participation requirements apply to the portion of a §401(k) plan that provides for contributions other than elective, employee, and matching contributions (e.g., “profit sharing contributions”)?

Proposed Answer: The mandatory disaggregation rules in Reg. § 1.401(b)-7(c) treat the portion of a plan that is a §401 (k) plan and the portion of a plan that is not a §401 (k) plan as separate plans. Therefore, the exception in Treas. Reg. § 1.401 (b)-6(g) does not apply to that portion of the §401 (k) plan that provides for contributions other than elective, employee, and matching contributions.

The mandatory disaggregation rules in Treas. Reg. § 1.401 (a)(26)-2(d) do not require treating the portion of a plan that is a §401(k) plan and the portion of a plan that is not a §401(k) plan as separate plans. Therefore, the exception in Treas. Reg. § 1.401 (a)(26)- 1 (b)(4) should apply to that portion of the 401 (k) plan that provides for contributions other than elective, employee, and matching contributions.

IRS Response. If the plan provides additional employer contributions, the 95% rule would not be available for the plan under either 401(a)(26) or 410(b). The special rule only applies if the plan provides elective deferrals, employee contributions, and matching contributions.

11. §401(k) Cash or Deferred Arrangements

For purposes of determining whether there is a successor plan relating to distributions upon termination of a §401(k) plan, is the date of the termination of the plan the date on which the board of directors adopt the resolutions, the date on which the plan amendment (terminating the plan) is effective, or the date on

which the plan assets are actually distributed to participants?

Proposed Answer. The date should be the effective date of the resolution terminating the plan, which is the date on which full vesting must occur.

IRS Response. The date of termination generally depends on the terms of the plan, and usually is the later of the adoption date or the effective date. But if assets are distributed as soon as administratively feasible, Rev. Rul. 89-87 may consider the plan as not terminated.

12. §401(k) Hardship Distributions

Is a participant who receives a hardship withdrawal entitled to later repay that amount to the plan?

Proposed Answer. Regulation §1.411(a)-7(d)(4) only requires that the plan permit repayments if the distribution was made by reason of the termination of the employee's participation in the plan. Because the employee's participation would not be terminated by reason of an in-service withdrawal, the plan is not required to allow repayments.

IRS Response. No buyback is required. A buyback is required only if there is a forfeiture upon the distribution.

13. §401(m) Matching Contributions

Can the amount of a participant's deferrals that are withdrawn during the year (e.g., because of a hardship withdrawal or a distribution following termination of employment) be disregarded for purposes of §401(m)?

Proposed Answer. If the amounts are withdrawn before the end of the year in which they are contributed, it is as if the employee hadn't contributed those amounts. Accordingly, no matching contribution should be required.

IRS Response. Elective deferrals that are withdrawn during the year are still considered elective deferrals for the year and so all the rules for elective deferrals must apply to such amounts. It should be possible to draft a plan that only matched elective deferrals that are still in the plan at the end of the year.

14. §401(m) Matching Contributions

If matching contributions are conditioned on an employee working 1,000 hours in a plan year or being employed on the last day of the plan year, are participants who do not satisfy the eligibility criteria included in the ACP test or are they excluded? Assume after-tax employee contributions are not permitted under the plan.

Proposed Response: Participants who do not satisfy the eligibility criteria are excluded from the ACP test. Excluding participants who do not satisfy a 1,000 hour requirement is consistent with the §410(b) rules for determining whether an employee is "benefiting" under the §401(m) plan for the plan year. Excluding participants who are not employed on the last day of the plan year is consistent with the definition of eligible employee in Reg. §1.401(M)-1(f)(4)(i), which excludes employees subject to an additional service requirement unless the service is actually performed.

IRS Response. The IRS agrees with the proposed answer. The ACP test considers employees only if they are eligible for a match under the terms of the plan.

15. §402(c) Eligible Rollover Distribution

Must a participant be allowed to rollover a hardship distribution?

Proposed Answer: No. While the direct rollover regulations do not except hardship distributions, a rollover of a hardship distribution negates the immediate financial need on which the distribution must be based. Since a rollover of a hardship distribution is inconsistent with a hardship distribution, allowance of a rollover should not be required.

IRS Response. There's no exception from the definition of eligible rollover distribution for a hardship distribution, nor is there an exception from the direct rollover rules for hardship distributions. The fact that an employee wants to rollover a distribution does not necessarily mean there is not a hardship. For example, the employee could receive a distribution for 12 month's tuition, and leave the funds in an IRA until the tuition for each school term was due.

16. §404 Deduction Limits

§404(a)(3)(A)(i) limits an employer's annual deduction for contributions to a profit sharing or stock bonus plan to 15% of the compensation paid or accrued to "beneficiaries" under the plan. What is the meaning of the term "beneficiaries" under the plan for purposes of applying this deduction limitation? Does the §404(a)(3)(A)(i) deduction limitation apply separately to a §401(k) cash or deferred arrangement that is part of a profit sharing or stock bonus plan? How does the §404(a)(3)(A)(i) deduction limitation apply to a profit sharing or stock bonus plan which allocates contributions on a non-uniform basis, such as a top-heavy plan within the meaning of §416?

Proposed Answer: §404(a)(3)(A)(i) provides that an employer's deduction for contributions to a profit sharing or stock bonus plan is limited to "an amount not in excess of 15% of the compensation otherwise paid or accrued during the taxable year to the beneficiaries under the stock bonus or profit-sharing plan." The Code does not define the meaning of "beneficiaries" under the plan.

In Rev. Ruling 65-295, a profit sharing plan provided that a terminating employee did not receive an allocation of the employer contribution in the taxable year in which the employee terminated employment. The IRS held that the compensation of terminating employees cannot be included in the total compensation paid or accrued during the taxable year for purposes of determining the deduction limitation. Further, in *Dallas Dental Lab, Inc. v. Commissioner*, 72 T.C. 117 (1979), the Tax Court held that the compensation of terminating employees who were plan participants,

but who terminated employment before becoming vested in the plan (so that any employer contribution in the year of termination was immediately forfeited), could not be included in calculating the 15% deduction limitation. The Tax Court's rationale was that these individuals never had any expectation of benefiting under the plan.

Based on the above guidance, the term "beneficiaries" under the plan for purposes of applying the 15% compensation deduction limitation of §404(a)(3)(A)(i) means an individual who (1) is a participant in the plan, (2) received an allocation of the employer's contribution to the plan and (3) is at least partially vested in his account balance under the plan, if the employee terminates service during the year.

No authority requires the disaggregation of the §401(k) component of a profit sharing plan for purposes of calculating the deduction limitation under §404. Thus, if an employee actually makes pretax contributions under a §401(k) component of a profit sharing plan, then that employee is a "beneficiary" under the plan and that employee's compensation is counted for purposes of determining the plan's deduction limitation—even if the employee does not receive an allocation of any employer profit sharing contributions (because, for example, of an hours of service or year-end employment allocation requirements). Finally, the compensation of every employee who receives an allocation of the employer contribution under the plan, even if the only allocation is the top-heavy contribution, is counted in determining the plan's deduction limitation.

IRS Response. The separate plan rule for 401(k) plans does not limit the 404 maximum deduction. Employees that are eligible to defer can be considered in determining the deduction limit.

17. §410(a) Participation Standards

Assume an employee switches from union to non-union status after having satisfied the applicable age and service conditions. Must the individual commence

participation immediately, or can it be deferred until the plan's next entry date?

Proposed Answer. An employee becoming eligible because of a change in status should not be treated better than an employee who has been in an eligible status all of the time. If the employee had been in an eligible category all of the time, the employee would have to wait until the plan's next entry date to commence participation after satisfying the eligibility conditions. The same rule should apply here.

IRS Response. Reg. 1.410(a)-4(b) provides some rules governing entry dates. The IRS considers an employee who changes category as somewhat similar to an employee who terminates and returns to service, and so that employee might have to be included in the plan immediately.

18. §411 Cash Out/Buy Back of Distributions

A participant terminates her employment and takes a single sum distribution from her former employer's defined contribution plan of her entire vested interest in that plan (but she was not fully vested in her account), rolls over her entire distribution into an IRA, and 3 years later returns to employment with the same employer. Upon her return to employment, she repays to the plan the entire amount previously distributed to her (by writing a check to the plan - NOT touching her rollover IRA). How should the plan treat the repaid amounts and what is the proper reporting of this repaid amount when the participant subsequently terminates employment again? Could she have repaid the previously distributed amounts via transfer of that portion of her IRA which represented those amounts (i.e., IRA balance minus earnings since initial rollover)? If so, what is the treatment inside the plan?

Proposed Answer: Repaid amounts are treated like after tax contributions (but not subject to §401(m) testing) so that participant has basis. On subsequent distribution, they are reported on 1099R as if they were really after tax contributions (so that those amounts cannot be rolled over a second time).

Nothing appears to prohibit satisfying the repayment rule by rolling back the appropriate amount from the rollover IRA. This would be treated by the plan like any other rollover contribution and would be reported on the 1099R as taxable/rolloverable income.

IRS Response. Funds in a conduit IRA can be used to buyback benefits, but it is not mandated that conduit IRA funds be used. An employee can use other funds, and therefore have basis on the buyback but such contribution would not have to be tested under 401(m) or 415. The employer may ask the employee if the funds are from an IRA in order to correctly treat the funds as basis or not.

19. §411(a)(8) Normal Retirement Age

Can an employer amend its plan to change the definition of normal retirement age from age 65 to age 67 so long as there is no violation of §204(g)?

Proposed Response: No, normal retirement age must be defined at age 65 (or 5 years after an employee begins working) for all purposes including receipt of a full unreduced benefit amount. But see, *Lindsay v. Thiokol*, No. 94 CV 174B (D. Utah 1996), on appeal No. 96-4033 (10th Cir.) (amendment changing normal retirement age to age 67 does not violate ERISA, relying on IRS' grant of application for tax qualification).

IRS Response. The IRS agrees with the proposed answer. The latest normal retirement date permitted under the statute is age 65. The IRS was unable to locate the case in the time before the meeting, and so has no comment on the decision. A plan with a determination letter would have reliance on the plan's qualified status. Normal retirement age is used for both vesting and the accrual rules. Using an age 67 normal retirement age for benefit accrual may create a problem under the accrual rules.

20. §411(d)(6) Anti-Cutback Rule

Regulation § 1.411(d)-4, Q&A-3(b)(2) states that an elective transfer must satisfy the nondiscrimination

requirements of §401(a)(4). Does this mean that you cannot have an elective transfer in the context of a sale of assets where the purchaser will only be hiring a few of the key executives of the seller (who are all highly compensated employees)?

Proposed Answer. The nondiscrimination test should be satisfied by applying it to the class of individuals actually hired.

IRS Response. Elective transfers are treated as an optional form of benefit and the fact that a third party has hired only certain employees is not a reason to discriminate in those employees eligible for an elective transfer.

21. §411(d)(6) and §401(1)

Reg. § 1.401 (1)- 1 (c)(7)(iii) specifies that “A Plan must generally provide that an employee’s covered compensation is automatically adjusted for each plan year.”

Reg. § 1.401(1)-l(b) reads as follows:

(b) Relationship to other requirements. Unless explicitly provided otherwise §401 (1) does not provide an exception to any other requirement under §401(a). Thus for example even if the plan complies with §401(1) the plan may not provide a benefit lower than the minimum benefit required under §416. Moreover a plan may not adjust benefits in any manner that results in a decrease in any employee’s accrued benefit in violation of §411(d)(6) and §411(b)(1)(G). However a plan does not fail to satisfy §401 (1) merely because in order to ensure compliance with §411 an employee’s accrued benefit under the plan is defined as the greater of the employee’s previously accrued benefit and the benefit determined under a strict application of the plan’s benefit formula and accrual method. See §401 (a)(15) for additional rules relating to circumstances under which plan benefits may not be decreased because of increases in social security benefits.

Is the language in Reg. § 1.401(1)-l(b) to be read to require that the adjustment of covered compensation is to be deferred each year for each participant until the participant’s accrued benefit computed at the adjusted covered compensation level is at least equal to the participant’s accrued benefit computed on the basis of the covered compensation in effect as of the last day of the preceding plan year? In other words is there an implied requirement for a wear away or fresh start each plan year for each participant in connection with the required annual adjustment of covered compensation?

Proposed Answer: §411(d)(6) does require a wear away in connection with the required annual adjustment of covered compensation.

IRS Response. The IRS agrees with the proposed answer. An adjustment of covered compensation is treated as a plan amendment and benefits must be protected.

22. §411(d)(6) Anticutback Rule

Because the timing of the payment of a distribution is an optional form of benefits under Regulation § 1.411 (d)-4 Q&A- 1 (b) does not that prohibit amendments eliminating an immediate lump distribution upon termination of employment (and only permitting a delayed distribution)?

Proposed Answer. Yes.

IRS Response. The IRS agrees with the proposed answer.

23. §417 GATT Amendments

A hypothetical plan is a FAP plan with several annuity forms and a lump sum form. Benefits under the Plan can start as early as 55/5. Benefits are paid before employee’s age 55 only if a small cashout or to a spouse or minor child(ren) upon employee’s death. The present Plan bases lump sum benefits on the UP-1984 mortality table and the PBGC interest rate for the month preceding the month in which the

annuity starting date (“ASD”) occurs. In GATT terms, a one-month stability period and one-month lookback are used for the lump sum interest rate.

There are two issues with the present Plan lump sum actuarial assumptions:

- The Plan’s PBGC lump sum interest rate is published about 45 days before the ASD. More lead time in knowing the lump sum interest rate would ease administration and let retiring employees know their actual lump sum amount earlier.
- The Plan must start using the new GATT §417(e) assumptions by January 1, 2000.

Under the regulations, the new GATT §417(e) minimum lump sum interest and mortality assumptions are effective starting in 1995. However, the effective date may be optionally delayed, but not later than 1/1/2000, if the present Plan assumptions are used until the change to the new assumptions is made.

The sponsor wanted to amend the Plan to a 3-month lookback with PBGC rates, using the “one-year rule” of Regs. § 1.417(e)-1(d)(3)(iv) [also included in Regs. § 1.417(e)-1 T(dX10)(ii)], to give more lead time in knowing the lump sum interest rate. With a 3-month lookback, the PBGC rate would be available about 3- 1/2 months before the ASD. Also, a 3-month lookback based on PBGC rates is consistent with a 5-month lookback with the 30-year T-bond rate. However, taking this action with PBGC interest rates eliminates the Plan’s ability to take advantage of the optional delayed effective date for adopting GATT assumptions. Also, this type of a change would introduce into the Plan an interest rate assumption basis that after 1994 is not considered a §417(e) lump sum interest rate and therefore not eligible for the anti-cutback exception.

Using a one-month lookback works for the present Plan because the PBGC rate for this month is published about 45 days in advance of the ASD. Practically speaking, a one-month lookback will not work under

GATT because the §417(e) 30-year T-bond rate is an average rate for a month and the applicable rate for the month prior to the month with the ASD will not be published until after the ASD. A two-month lookback reduces the lead time for knowing the lump sum interest rate to less than 30 days prior to the ASD. A three-month lookback increases slightly, by about one week, the lead time for knowing the lump sum interest rate. Therefore, when the Plan adopts GATT, a change to a 3-month lookback has to be made just to keep the Plan in the same position as pre-GATT.

Going to a five-month lookback, which provides the most lead time for lump sum interest rate determination, and/or changing the present Plan stability period requires a two-step amendment process and that the Plan comply with the “one-year test”.

To get to a five-month lookback with anti-cutback relief, the Plan has to go through a two-step amendment process. Amendment One: The Plan adopts GATT assumptions with a three-month lookback and a monthly stability period. This gets the Plan anti-cutback relief to change to GATT assumptions. Amendment Two: “Some time” after Amendment One, the Plan adopts a five-month lookback and the desired stability period with the “one-year test” based on Amendment One and Amendment Two. This gets the Plan anti-cutback relief to change the timing for determining the §417(e) lump sum interest rate.

How long is “Some time” after Amendment One. Can it be immediately? Building on the “one-year test”, is it one year?

Proposed Answer: The second amendment should be eligible to be made immediately.

IRS Response. The IRS is not sure two separate amendments are needed. One amendment can shift both the rate and the time for determining the rate.

24. §417(e)(3)(B) and Temporary Regulations

The transition rules in §417(e) provide for GATE interest and mortality assumption rules to be effective

for plan years after December 31, 1999 or if earlier, the date GATT rules are adopted by the Plan. This transition rule applies to plans adopted and in effect before the GATT enactment date. Between the GATT enactment date and the effective date of GATT, distributions are to be made on the basis of the plan provisions if the Plan provisions complied with § 417 as in effect on December 7, 1994, the day before the December 8, 1995 enactment date of GATT.

Does this language prohibit amendment of distribution provisions of an existing plan that in any way affect cashouts or lump sum distributions without adoption of the GATT assumptions? For example, can larger than \$3500 cash-out be offered with consent, can lump sums be offered on the basis of the cash out assumptions that satisfy §417(e) as in effect before the enactment date of GATT that already appear in the plan? If the 417(e) PBGC rate is used by the plan for cash-outs, can it continue to be used during the transition period for larger than \$3500 cash outs? Can the 120% rule be adopted for cash-outs larger than \$25,000 without triggering immediate adopting of the GATT assumptions?

Proposed Answer: Yes to all questions.

IRS Response. The IRS agrees with the proposed answer. To the extent a plan is extending lump sum provisions, that is not going to eliminate access to the grandfather provisions.

25. §417 QJSA Requirements

Can a defined contribution plan limit the amount of the qualified joint and survivor annuity benefit payable to the surviving spouse to 50% of the account balance? §417(c)(2) and Reg. § I.401 (a)-20, Q&A-4 (allowing a benefit of only 50% of the account balance) only refer to preretirement survivor annuities.

Proposed Answer. The same result should apply whether the benefit is paid in the form of a preretirement survivor annuity or a joint and survivor annuity.

IRS Response. The IRS disagrees with the proposed answer. The 50% rule only applies to preretirement survivor annuities.

26. §417 QJSA Requirements

Is spousal consent required under §417(a)(4) with respect to a renegotiation or extension of a loan?

Proposed Answer. Yes. This should be treated the same as a new loan.

IRS Response. The IRS agrees with the proposed answer. Reg. 1.401(A)-20, Q&A 24(c) is very clear that renegotiation or extensions of loans are treated as new loans for purposes of the spousal consent requirements.

27. §417 QJSA Requirements

Assume that after all of the consent forms have been completed with respect to the termination of a defined benefit plan there is a small increase in the benefits payable under a plan that is subject to the joint and survivor annuity requirements, which increase is approximately 1% of the total benefits. Must the plan obtain new consents with respect to persons whose benefits exceed \$3,500?

Proposed Answer. No, the original consent should be effective as to the increased amount.

IRS Response. If the additional amounts relate to the original annuity starting date, new consents will not be required. If the increase in benefits were significant, the plan sponsor should consider obtaining new consents because the employee's election for the new amounts might be different than for the original distributions.

28. §423 Incentive Stock Options

Does the addition of a stock appreciation right ("SAR") to an ISO (that has already been granted) constitute a

modification within the meaning of §424(h)(1)?

Proposed Answer. No, the addition of the SAR in no way increases or decreases the benefits to be derived from the exercise of the ISO.

IRS Response. The IRS disagrees with the proposed answer. Giving employees the right to enjoy benefits without an outlay of cash is a new benefit.

29. §4980 Reversion Excise Tax A defined benefit plan with excess assets that covers salaried employees is terminated. 25 percent of the excess assets are transferred to a replacement plan that is a defined contribution plan covering both salaried employees and hourly employees. All the salaried employees that were covered by the terminated defined benefit plan are covered under the defined contribution plan. The excess assets are allocated in accordance with §4980(d) to all participants in the defined contribution plan. Is the defined contribution plan a qualified replacement plan under §4980(d)(2)?

Proposed Response: Yes. In order to be a qualified replacement plan, 95% of the active participants in the terminated plan who remain as employees of the employer after the termination must be active participants in the replacement plan. The fact that additional employees are covered by the plan or share in the allocation of excess assets is irrelevant.

IRS Response. The IRS agrees with the proposed answer. The only requirement is that 95 % of the employees in the former plan benefit under the replacement plan. There is no problem with also covering additional employees.

30. §4980B Continuation Coverage

Prop. Reg. § 1.162-26, Q&A-18(c) provides:

if coverage is reduced or eliminated in anticipation of an event, the reduction or elimination is disregarded in determining whether the event causes a loss of coverage.

This apply only in the case of a reduction or elimination effected by the employer, or does it apply to one effected by the employee. For example, assume that an employee drops the health insurance coverage of his estranged spouse, and they later become divorced. Would she be entitled to elect continuation coverage as a result of the divorce?

Proposed Answer. This rule should only come into play if the coverage was reduced or eliminated by the employer, not by the action of the employee.

IRS Response. The IRS disagrees with the proposed answer. The IRS would like the spouse to have COBRA coverage in the described example.