

ABA Joint Committee on Employee Benefits
GOVERNMENT AGENCIES MEETINGS

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

Internal Revenue Service Questions and Answers

1. §72(p) and Treas. Reg. 1.401(k)-1(d)(2) - Plan Loans And Hardship Distributions.

May a tax-qualified defined contribution plan limit the availability of plan loans to only those participants who satisfy the plan's hardship distribution rules?

Generally, there is no requirement that a participant who receives a hardship withdrawal must pay back the amount of the hardship withdrawal. In order to qualify for a hardship distribution, participants must first have exhausted his or her ability to receive a plan loan. In addition, the hardship withdrawal is subject to 20% mandatory withholding (because the distribution is not being rolled over) and the 10% penalty on early withdrawal if the participant is under age 59 1/2. Additional taxes may also apply to the distribution. Thus at a time when the participant has financial difficulties, the amount otherwise available to the participant is reduced by at least 30%.

By making plan loans only available to participants who meet the plan's hardship standard, the plan achieves two goals: (1) it reduces the number of participants who will take plan loans and thereby improves the likelihood that such participants will have retirement income; and (2) it permits those participants who qualify for a hardship distribution to have earlier access their plan benefits but also preserves the opportunity for such participants to repay the loan and thereby increase the likelihood that such participants will have retirement income.

The plan provision will not discriminate in favor of HCEs because it is a benefit, right or feature which is uniformly available to all plan participants.

Proposed Answer: A defined contribution plan should be permitted to limit loan availability to participants who satisfy the plan's hardship standard.

IRS Response: The IRS agrees with the proposed answer. A defined contribution plan can limit loans to participants that have taken hardship distributions. The IRS noted the Thrift Savings Plan for federal employees used to have such a provision, though that restriction was recently lifted.

2. §125 & 403(b) - Cafeteria Plans & Tax-Sheltered Annuities

A tax-exempt employer has an arrangement that offers employees a choice among various types and levels of generally excludable employee and dependent medical insurance, employee group term life insurance (including coverage in excess of \$50,000 if elected by the employee) and 403(b) contributions. Is this arrangement permissible if the plan is funded as a salary add-on, and is not funded by employee salary reduction contributions?

Proposed Answer: Yes, the arrangement is permissible and does not result in constructive receipt of income. Because the employees never have the opportunity to receive cash, the arrangement is not a cafeteria plan under §125. The only income that would be received by employees would be to those employees who elect group term life insurance in excess of \$50,000. A cafeteria plan is not necessary if there is no salary reduction and if the only choices are among excludable benefits. Since there is no cafeteria plan, the deferral of compensation under §403(b) is permissible, although 403(b) annuities must be part of a plan that satisfies the qualified plan requirements specified in §403(b)(12)(A)(i).

IRS Response: The IRS disagrees with the proposed answer. This is a flexible benefit arrangement, rather than a §125 plan. Because the life insurance benefit in the plan is in excess of \$50,000, there is a taxable option under the plan and that throws off the intent of the question because it creates a §125 problem. If the life insurance benefit were for an amount of coverage of \$50,000 or less, the plan would probably be okay and a 403(b) contribution would be allowed.

3. §162(m) - Excessive Employee Remuneration

Assume a publicly-traded employer provides its CEO with cash compensation in excess of \$1,000,000. Assume further that the CEO is required to relocate his home and incurs a loss on the sale of his home. Can the employer deduct its reimbursement to the executive for the amount of his loss without regard to the dollar limitation of Section 162(m)?

Proposed Answer. No.

IRS Response: The IRS agrees with the proposed answer.

4. §162(m) - Excessive Employee Remuneration

Treasury Regulation Section 1.162-27(f)(2)(ii) says that the transitional rule for options granted before the company goes public expires when the plan is materially modified. Is this limited to a material modification that occurs after the IPO?

Proposed Answer. Yes. Because Section 162(m) only applies to publicly held corporations, the material modification must have occurred after the IPO.

IRS Response: The IRS agrees with the proposed answer. Because §162(m) applies only to publicly held corporations, the material modification must occur after the IPO.

5. §162(m) - Excessive Employee Remuneration

Treasury Regulation Section 1.162-27(f)(2)(ii) says that the transitional rule expires when there is a material modification of the plan or agreement. However, Treasury Regulation 1.162-27(f)(2)(ii) says that if an option was granted before the material modification of the plan, then the exercise of that option is, in essence, grandfathered. Assuming an option is materially modified, but the plan is not materially modified, is the grandfather lost for that option?

Proposed Answer: Yes. Material modification of the option is the same as material modification of the plan.

IRS Response: The IRS agrees with the proposed answer.

6. §401(a)(4) - Highest Paid 25 Employees Distribution Restrictions

Where a plan that is in the process of terminating and has issued a notice of intent to terminate, may the benefit of a terminated highly compensated employee, which would be restricted under section 1.401(a)(4)-5 without a plan termination, be distributed in a lump sum before distributions are made on account of plan termination (which would be after government approvals are received)?

Proposed Answer: The IRS has held that a plan's termination date is the date set forth in the notice of intent to terminate. See Rev. Rul. 97-237 and 89-87. Thus, the restrictions do not apply.

IRS Response: The IRS disagrees with the proposed answer. The plan termination date is not controlling for these purposes. The act of terminating a plan is a process and while a plan is undergoing that process the plan must comply with the various qualification requirements, including the high 25 distribution restrictions. A plan should not distribute benefits to restricted employees without complying with the high 25 rules as long as there are benefits owed participants. The distributions could be made under a security arrangement permitted by the IRS. After the plan has terminated in a standard termination and all benefits have been paid and the assets have been distributed, the security arrangements could lapse because there would not be any entity for the security interest to run to.

7. §401(a)(9) - Minimum Distributions

An individual who is reaching age 70½ must take a minimum distribution from his individual retirement account (IRA). Can publicly-traded stock be distributed from the IRA directly to the individual's personal brokerage account (i.e., "in kind") so that the individual does not incur brokerage commissions in a sale of the IRA's holdings and then a purchase by the individual account?

Often, a transfer of stock between an individual and the individual's IRA is considered a prohibited transaction (i.e., a sale by the IRA to the individual). Similarly, we know that except for rollovers, annual contributions must be in cash. On the other hand, reg. §1.408-4 speaks of "any amount paid or distributed" as being taxed to the individual, which would indicate that something can be distributed (such as stock) without being "paid" in cash.

Proposed Answer: A distribution of stock as part of a minimum required distribution is not a transaction, because the IRA receives nothing in exchange. It is simply a distribution that diminishes the value of the IRA, and produces taxable income to the individual. The fact that the stock is publicly traded eliminates any concern over valuation.

IRS Response: The IRS agrees with the proposed answer. There is no prohibited transaction upon a distribution of property in kind. The fact that the stock is publicly traded is not crucial; while valuation is an issue for non-publicly traded stock, property can be distributed from a plan and it is not a prohibited transaction. A recent WSJ article focused on the valuation of limited partnership interests in IRAs, and the same thing could happen in qualified plans. The IRS is aware of the issue concerning valuation of difficult to value property.

8. §401(a)(11) - QJSA Requirements

A plan that is subject to QJSA rules is required to provide a "general explanation of the relative financial effect" of waiving the QJSA. Treas. Reg. §1.401(a)-11(c)(3)(C).

- Are plan administrators required to quote dollar amounts? How is this done if the plan administrator does not have the necessary demographic data? Is the plan administrator required to provide a sample table of actuarial adjustments, or to disclose the actuarial basis for the adjustment, other than in response to a request for more information?
- If so, must they do so for all other forms of payment available under the plan?
- Are they required to do so for unmarried participants, to whom the QJSA rules do not apply?
- In disclosure for waiver of a QPSA for a currently-employed participant, how much information must be provided to the spouse regarding the possibility that the value of the benefit may increase in the future, either through additional accruals or through earnings on a defined contribution plan account?

Proposed Answer: The general explanation means that you have to tell a participant that a QJSA payment is less than a single life annuity payment, but that you are not necessarily required to quantify the amounts, unless the participant or spouse requests the information, and provides all data (such as dates of birth) that are necessary to calculate the value of the QJSA. Plans are not required to provide the general explanation of benefits to unmarried participants. No information regarding the possibility of future increases has to be provided because there is no guaranty of future employment or future continuation of the plan.

IRS Response: The IRS does not believe plan administrators have to quote dollar amounts. It would be clearly acceptable to have tables showing hypothetical annuity values at different age in order to show relative values. Giving actuarial factors is not required but could substitute for showing dollar amounts at different ages and amount of benefits. If the plan has an option, it should disclose it to the participant. For unmarried participants, the QJSA is a single life annuity, so those factors would have to be disclosed. Additionally, 411(a)(11) requires notice to the participant, so even if the QJSA requires didn't apply to unmarried participants the notice would have to be given. For the waiver of a QPSA, the IRS has never required that the participant be told they will earn more benefits with additional service and compensation, but the regular plan communication should have disclosed this type of information. The IRS indicated that if the plan administrator made a good faith attempt to comply with the notice requirements, agents should be reasonable.

9. §401(a)(11) - QJSA Requirements

Assume a participant wants to name as beneficiary a living trust, pursuant to which the participant and spouse serve as the trustees. Is spousal consent required in this case?

Proposed Answer: Not as long as the spouse is the primary beneficiary of the living trust.

IRS Response: The IRS disagrees with the proposed answer. While not addressing other issues that occur when a trust is a beneficiary, the IRS indicated the payment of benefits to someone or something other than the spouse requires spousal consent.

10. §401(a)(11) - QJSA Requirements

Section 1.401(a)-20, Q&A-25(b)(3) provides that a participant's divorce does not invalidate any elections made while the participant was married, unless otherwise provided in a QDRO, or the participant changes them or remarries. What if the plan provides that upon the participant's divorce prior to his or her annuity starting date, any elections selecting benefits in the form of a survivor annuity are invalidated?

Proposed Answer. If the plan invalidates the election, that should be controlling.

IRS Response: The IRS disagrees with the proposed answer. The regulation controls the situation, and the plain language of the regulation indicates the divorce does not invalidate any elections made while the participant was married. The plan cannot change that result. The answer would be different for an IRA, since individual retirement savings arrangements are not subject to the QJSA rules. §417 requires participants must be given these elections, and that doesn't apply to IRAs. The IRS didn't see a problem with IRA documents that revoke elections upon a divorce of the owner.

11. §401(a)(13) - Anti-alienation Rule & Exchanging Checks

For administrative reasons, it may be more feasible to make loans or other distributions to participants through an exchange of checks. That is, when a withdrawal is requested, the mutual fund (or other investment vehicle used by the trust) will make the check payable to the employer or the trustee. (If the check is payable to the trustee, the check is endorsed to the employer.) The employer then writes an equivalent check to the participant. The employer check is written and transmitted on the same day (or occasionally the next business day) after the trust check is received. The employer receives no benefit (float or otherwise) from this check exchange.

Does this violate section 401(a)(13)? Can the exchange of checks be treated as if the employer check is a check from the trust for all purposes?

Proposed Answer: Because the employer does not benefit, the fact that the distribution is made by an employer check should be ignored. The substance of the transaction is a distribution from the trust, not an impermissible alienation under section 401(a)(13).

IRS Response: The IRS disagrees with the proposed answer. The IRS believes the proposed transaction violates the anti-alienation rule of 401(a)(13), might violate the vesting requirements of 411, and may be a prohibited transaction under §4975. The check should go from the trust to the employee, not the employer. In response to a question from the audience on the DOL class exemption for loans from an employer to a plan for plan administrative expenses, including benefit payments, the IRS indicated that this transaction did not seem to fit the terms of the exemption and that the agencies sometimes disagree.

12. §401(a)(17) - Compensation Limit for Government Employers.

§13212(d)(3) of OBRA 93 contains a special transition rule relating to the application of the §401(a)(17) compensation limit to certain participants in a governmental plan, provided that the plan is amended to incorporate the §401(a)(17) compensation limit for plan years beginning after December 31, 1995. The remedial amendment period for governmental plans is the last day of the first plan year beginning or after the later of January 1, 1999 or the 1999 legislative date.

Will an amendment that is adopted on the last day of the remedial amendment period for governmental plans and that applies the §401(a)(17) compensation limit for plan years beginning after December 31, 1995 satisfy the OBRA 93 transition rule requirements?

Proposed answer: The transition rule requires that the plan is amended to incorporate the §401(a)(17) compensation limit for plan years beginning after December 31, 1995, but it does not require when that amendment be actually adopted by the sponsoring employer. As long as the plan is operated in accordance with the regulations under §401(a)(17), including the special transition rule, a plan amendment adopted by the end of the remedial amendment period that applies the provisions of §401(a)(17) to the plan, including the special transition rule, will comply with the transition rule requirements.

IRS Response: The IRS agrees with the proposed answer. The IRS cautioned, however, that such a retroactive amendment might be a problem under applicable state law. This is not an IRS issue, but might present a problem for the plan.

13. §401(b) - Remedial Amendment Period.

When does the remedial amendment period end for a plan sponsored by a tax-exempt employer (other than non-electing church plans) with respect to the compensation limit under §401(a)(17)?

Announcement 95-48 indicates that the date by which plans must comply with §401(a)(17) is not extended and the regulations under that section are effective for plans sponsored by tax-exempt employers for plan years beginning on or after January 1, 1996. This is different from the effective date for the regulations under most of the nondiscrimination requirements, which apply to plans sponsored by tax-exempt employers only for plan years beginning on or after January 1, 1997. But the

announcement also indicates that "the remedial amendment period for plans maintained by tax-exempt organizations (other than nonelecting church plans) is extended to the last day of the first plan year beginning on or after January 1, 1997."

Proposed Answer: The fact that the §401(a)(17) regulations are effective for the 1996 plan year does not change the remedial amendment period with regard to that section. The remedial amendment period for all TRA 86 and later qualification provisions for plans maintained by tax-exempt employers, including §401(a)(17), expires on the last day of the plan year beginning in 1997.

IRS Response: The IRS agrees with the proposed answer.

14. §401(k) & (m) - Multiple Use Test

As a result of the SBJPA of 1996, changes to the ADP and ACP test correction methods, once excess contributions are corrected, the ADP test cannot be rerun, because the corrections will not necessarily reduce the percentages enough to pass the test. However, the multiple use test requires using the ADP and ACP tests after the excess contributions are distributed. Will the multiple use test be continued after 1996?

Proposed Answer: The multiple use test in its current form will not apply after 1996 under the simplification rules because the ADP and ACP test are not to be rerun after the excess contributions are returned.

IRS Response: The IRS disagrees with the proposed answer. The IRS noted that Notice 97-2 describes how to do the multiple use test under the new ADP correction procedure. Essentially, the multiple use test is done using the hypothetical percentages used in the correction procedure, not the actual deferral percentages of the HCEs after the corrective distributions are made. If the rules expressed in the Notice do not work, the IRS solicited comments, but noted that nothing in the SBJPA repealed the multiple use test.

15. §401(k) & 413 - Multiple Employer Cash or Deferred Arrangement Nondiscrimination Testing

Assume that in 1996, Employers A, B, C, D and E are participating Employers in a Section 413(c) multiple-employer 401(k) Plan and the Employers D and E are part of the same controlled group under Section 414(b) ("Controlled Group DE"). Further assume that effective 1/1/97, Employer A becomes part of Controlled Group DE.

In applying the ADP test for Controlled Group DE for the 1997 plan year, are the 1996 elective deferrals of nonHCEs of Employer A taken into account?

Proposed Answer: No. Since Employer A was not part of Controlled Group DE during 1996, for purposes of the 1997 ADP testing for Controlled Group DE, only 1996 elective deferrals of those nonHCEs that were part of Controlled Group DE in 1996 (i.e., nonHCE employees of Employers D and E) should be considered. The 1996 elective deferrals of nonHCEs of Employer A are not relevant for this purpose.

IRS Response: The IRS noted that it solicited comments in Notice 97-2 on the appropriate determination of the prior year's ADP for NHCEs when the group of employees tested is significantly different in the current year than in the prior year. The IRS does not have a specific answer for this question at this time.

16. 401(k) & 416- Safe Harbor Contributions & Top-Heavy Requirements

How do the 401(k) safe harbor formulas mesh with the top heavy rules under §416?

Proposed Answer: None.

IRS Response: The nonelective contribution made pursuant to the 401(k) safe harbor should be considered an employer contribution for purposes of the top heavy requirements. The existing top heavy regulations, at M-18 & M-19, indicate that qualified nonelective employer contributions are treated as employer contributions for purposes of the minimum contribution requirements. If matching contributions are used to satisfy the 401(k) safe harbor, those contributions cannot be considered top heavy minimum contributions.

17. §408 - SEP-IRA

May a highly compensated employee or unincorporated sole proprietor or partner waive participation in a SEP-IRA?

Proposed Answer: Such a waiver should be acceptable if it is irrevocable and made when such individual is first eligible for plan participation.

IRS Response: The IRS disagrees with the proposed answer. A highly compensated employee could not waive participation in a SEP-IRA without adverse tax consequences for the plan. The Code requires all employees be covered by the plan, and there is no exception for employees that would elect out of coverage. The same answer should apply for the new SIMPLE plans.

18. §408 – IRA Rollover

Section 408(d)(3)(A)(ii) provides for the rollover of a distribution from a “conduit” IRA which is defined as an IRA no part of which is attributable to any source other than a rollover contribution from a qualified plan. If multiple distributions from multiple qualified plans have been rolled over into a single IRA, will that IRA qualify as a “conduit” if no other contributions had been made to it?

Proposed Answer: An IRA will be treated as a “conduit” regardless of the number of contributions to it as long as each contribution is a rollover contribution from a qualified plan.

IRS Response: The IRS agrees with the proposed answer. There is no rule requiring segregation of rollovers from different plans in different IRAs. It is important for a conduit IRA is that only rollover contributions be used to fund the plan.

19. §410(a) - Participation Standards

The regulations under Code Section 410(a) provide that a rehired employee, who completed the minimum age and service requirements during prior employment and did not incur a one year break in service, must commence participation immediately upon rehire, without waiting until the next entry date, unless the prior service is ignored under the plan’s break-in-service rules. Reg. Sec. 1.410(a)-4(b)(1); Sec. 1.410(a)-4(b)(2), Example (3). Does this mean that a rehired employee must be able to sign up immediately for salary deferrals in a 401(k) plan? An immediate sign-up is virtually impossible to accomplish administratively, particularly when the employer has world-wide operations and multiple payrolls and the 401(k) plan is administered by a third-party administrator.

Proposed Answer: The rehired employee becomes a participant in the 401(k) plan immediately for purposes of section 410(b), but does not become an active participant until salary deferrals start. A rehired employee must be able to enroll for salary deferrals under substantially the same conditions as a continuing employee who has met the minimum age and service conditions but has not entered into a salary deferral arrangement.

The list of required modifications for qualified cash or deferred arrangements provides that a 401(k) plan “must specify a reasonable period at least once each calendar year during which a participant may elect to commence Elective Deferrals.” The rule is no different for rehires. A 401(k) plan may not impose a special additional waiting period for salary deferrals by rehires.

Of course, all service after rehire must be taken into account for vesting purposes and, if profit sharing contributions are made, they must be allocated with respect to all compensation paid after rehire.

IRS Response: The IRS agrees with the proposed answer. It is not possible to retroactively put the participant in the same place they would have been in if they had commence participation in a 401(k) plan immediately upon rehire, since deferral elections must be made before the amounts are currently available.

20. §410(a) – Participation Standards

Code Section 410(a)(5)(C) provides that, in computing an employee’s period of service in the case of any participant has any 1-year break in service, service before such break shall not be required to be taken into account under the plan until the participant has completed a year of service after return. Upon completion of one year of service, participation must be retroactive to the date of rehire, and all service after rehire must be taken into account. See Reg. Sec. 1.410(a)-4(b)(2), Example (2) and Reg. Sec. 1.410(a)-5(c)(3).

What does it mean to have participation be retroactive in a 401(k) plan?

Proposed Answer: The rehired employee becomes a participant in the 401(k) plan retroactively for purposes of section 410(b), but does not become an active participant until salary deferrals start. Salary deferrals cannot be made retroactively.

Of course, all service after rehire must be taken into account retroactively for vesting purposes and, if profit sharing contributions are made, they must be allocated retroactively with respect to all compensation paid after rehire.

The IRS has routinely given determination letters to 401(k) plans that make use of the one year hold-out rule.

IRS Response: The IRS disagrees with the proposed answer. See also the prior question and answer.

21. §411(a)(2) - Vesting

A defined contribution plan uses unit value accounting with respect to each of the investment options under the plan. All transactions under the plan are processed based on the unit value as of the close of the New York Stock Exchange each business day. The plan trustee provides a daily unit value for each investment fund to the plan administrator and the plan administrator processes fund transfers and distribution. Periodically, due to the complexities of valuing large, diversified investment funds, the trustee may determine on a given day (day 2) that a positive or negative adjustment is necessary to the unit value for the prior day (day 1). Therefore, participants who received a distribution calculated based on day 1's unit value may have received a total distribution that was less than or greater than their vested account balance. Is the plan administrator required in all cases, regardless of the amount of the adjustment, to recalculate each participant's account and provide either a makeup distribution or seek a refund from affected participants.

Proposed Answer: Not in all cases. The plan administrator may adopt reasonable valuation procedures such that no retroactive adjustment is required to participants' account balances that are impacted below a specified, appropriate threshold, e.g., the lesser of \$50 or 1% of the participant's account balance.

IRS Response: The IRS disagrees with the proposed answer. The IRS is not aware of a de minimis rule under the vesting requirements that would allow a participant to forfeit a small portion of their benefit. The plan would have to make the adjustment, both for positive and negative adjustments. If the participant was paid too much, there might be a rule of reason so that the plan would not have to spend \$10 to recover \$1. A plan could, however, fix the date for determining the account balance to be distributed as a day in advance of the date of distribution. Plans can have reasonable approaches for valuing benefits or accounts, but once the accurate balance has been determined, that is the amount the participant must receive.

22. §411(a)(11) - Participant Consent to Distribution

Treasury Regulation Section 1.411(a)-11(e)(1) provides that a participant cannot be required to accept a distribution upon the termination of a defined contribution plan if the employer maintains another defined contribution plan. Is a Simplified Employee Pension ("SEP") treated as a defined contribution plan for this purpose, or is it limited to retirement plans that qualify under Section 401(a)? This same issue also arises under Treasury Regulation Section 1.411(d)-4, Q-2(b)(2)(iii) and (vi).

Proposed Answer. No. The distribution rules and the tax treatment of amounts received from SEPs are so different than those for qualified plans that SEPs should not be treated a defined contribution plans for this purpose.

IRS Response: The IRS agrees with the proposed answer. The account balance of a terminating qualified defined contribution plan could be distributed without participant consent even if the employer also sponsors a SEP or a SIMPLE.

23. §411(a)(11) - Participant Consent to Distribution

Assume that a participant received a hardship distribution from a Section 401(k) plan of \$2,000, which was his entire account balance at that time. Assume that subsequently the participant accumulated \$2,000 in his account. Can the subsequent \$2,000 be cashed out without the consent of the participant?

Proposed Answer. Yes. The test is whether there was more than \$3,500 in the participant's account at the time of any distribution.

IRS Response: The IRS agrees with the proposed answer, but noted that if the account balance at the time of the hardship distribution had been \$4,000, the later distribution could not be made without participant consent even if the account balance was still below \$3,500 at that time. The test is whether at an earlier distribution the account balance exceeded \$3,500, and then consent

would be required for all subsequent distributions. If the account balance was \$6,000 and the balance was evenly divided by a QDRO, the IRS did not believe the participant or the alternate payee would be charged with the other's benefit, so involuntary distributions could be made.

24. §411(d)(3) - Partial Terminations

How is it determined whether there has been a significant reduction in the number of participants in a multiple employer plan for purposes of the partial termination rules?

Proposed Answer: Whether there has been a significant reduction in the number of participants in a multiple employer plan is determined on a plan-wide rather than an employer-by-employer basis. See 413(c)(3); Treas. Reg. § 1.413-2(a)(3)(iii), (d) (section 411 applied as if all employers who maintain a multiple-employer plan constituted a single employer).

IRS Response: The IRS agrees with the proposed answer. When the regulations indicate section 411 is applied as if all employers constitute a single employer, that includes the partial termination rule. The partial termination determination is a plan-wide computation.

25. §411(d)(6) - Anti-cutback Rule

A plan has offered retirees a level income option, but in the last 30 years only a handful of participants have elected it. The plan sponsor wishes to eliminate the option for all participants except for those participants who are age 50 or older on the date the plan is amended to remove the option. Is this amendment a violation of §411(d)(6)?

Proposed Answer: No. Since few participants elect this option it is apparently not a valuable benefit and therefore should not be protected by §411(d)(6). Also, except possibly for those participants who are close to retirement age, few participants would have any expectation of receiving benefits under this option. Thus, protecting the option only for those close to retirement age should satisfy the objectives of §411(d)(6).

IRS Response: The IRS disagrees with the proposed answer. There is no rule that just because few participants have elected an option that the option is not entitled 411(d)(6) protection. The reference in the legislative history of 411(d)(6) that considers the fact that a benefit option is not valuable to be a reason allowing the elimination of a benefit is not guidance that permits employers to eliminate benefits they do not consider valuable.

26. §411(d)(6) - Anti-cutback Rule

A plan offers 5, 10, and 15 years certain and life annuity options. Can the plan sponsor eliminate the 10 years certain and life option without violating §411(d)(6)?

Proposed Answer: Yes. If a plan provides for 3 or more actuarially equivalent joint and survivor annuities, the plan may be amended to eliminate any of the options, other than the options with the largest and smallest optional survivor percentages. See reg. 1.411(d)-4, Q&A 2(b)(2)(ii). By analogy, the sponsor should be able to eliminate the 10 year certain and life option.

IRS Response: The IRS disagrees with the proposed answer. The IRS does not accept analogies to the 411(d)(6) regulations. If a situation is not exactly described in the regulations, benefits cannot be eliminated. The general rule applies that allows elimination of the benefit only with respect to benefits accrued after the date of amendment.

27. §414(q) - Definition of Highly Compensated Employee

One hundred percent of the stock of Company C is owned by F, who is also chief executive of the corporation. His wife W also works in the business, and earns more than \$80,000. Four of their children, A, B, C, and D, work in the business, but earn less than \$80,000. Two of their children's spouses, E and F, also work in the business and earn less than \$80,000. All of the children and their spouses are over age 21. For purposes of ADP and ACP testing, are the children and/or their spouses considered highly compensated employees?

Family aggregation rules were repealed by SBJPA, and therefore the children and their spouses should no longer be aggregated with F for purposes of determining who is a highly compensated employee. Family attribution rules under §414(b) and (c) would not attribute F's stock to his adult children or their spouses.

Proposed Answer: Before SBJPA, family members of a five percent owner or one of the 10 most highly paid HCEs were treated together with the direct owner or top 10 HCE as a single individual. SBJPA eliminates that rule. Now a 5-percent owner and a top-10-HCE are separate individuals with separate compensation.

However, SBJPA did not change who is a 5-percent owner, which is defined in §414(q)(3) (for purposes of the definition of a highly compensated employee) with reference to §416(i)(1). Section 416(i)(1)(B) refers to stock that a person "is considered as owning within the meaning of section 318)," with constructive ownership rules applied by substituting 5% for 50%. Code §318(a)(1) and Reg. §1.318-2 appear to require that all stock owned by a parent be attributed to his child, regardless of the age of the child (unlike the §414 rules). On the other hand, Reg. §1.318-1(b)(2) says that if stock would be included in the computation more than one time, it would be included only once, in the manner in which it will impute to the person concerned the largest total stock ownership. Could this be read to say that because 100% of F's stock is attributed to W, none is imputed to the children?

Even if the stock is attributed to A, B, C, and D, it appears that none is attributed to E and F, because spousal attribution cannot be tacked onto parent/child attribution, even under §318.

IRS Response: The IRS wishes to stress that while family aggregation has been repealed, stock attribution has not. The sole shareholder, his wife, and their four children are all considered HCEs, because of the stock attribution rule. Because the HCE aggregation rule has been repealed, however, they are all considered separate HCEs with their own compensation and benefit limits. Stock should not be attributed to E and F, because of the double attribution rule.

28. §414(q) - Definition of Highly Compensated Employee

Assume Employers X, Y and Z (who are not related to one another) are participating employers in a Section 413 (c) multiple-employer plan. Assume that in 1996, Employee A was employed for six months by Employer X and for six months by Employer Y and that he received \$50,000 of compensation from each Employer. Further, assume that in 1997, Employee A is employed only by Employer Y and will receive \$200,000 in compensation from Employer Y during that year.

Is Employee A an HCE of Employer Y for 1997?

Proposed Answer: No. Since Employee A did not receive compensation in excess of \$80,000 from Employer Y in 1996, Employee A should not be an HCE of Employer Y for 1997. The fact that Employee A received over \$80,000 in total compensation from the participating Employers under the Plan should not be relevant for this purpose.

IRS Response: The IRS agrees with the proposed answer. There is no reason to aggregate compensation for different employers in a multiple employer plan. The compensation is looked at independently for each employer, and it is irrelevant that they had total compensation under the plan from all employers that would exceed the HCE threshold.

29. §414(q) - Definition of Highly Compensated Employee

Assume the same facts as in the prior question, except that Employee A received \$100,000 of compensation from each Employer X and Y in 1996 and that effective January 1, 1997, Employee A becomes employed by Employer Z. Further, assume that Employee A will receive \$200,000 in compensation from Employer Z in 1997.

Is Employee A an HCE of Employer Z in 1997?

Proposed Answer: No. Since Employee A did not receive any compensation from Employer Z in 1996, Employee A should not be an HCE of Employer Z in 1996.

IRS Response: The IRS agrees with the proposed answer. Because of the change in the definition of HCE, only compensation in the prior year is used to determine HCE status, and Employee A did not have any compensation from Employer Z in the prior year.

30. §415(b) - Limitation on Benefits Under Qualified Plan

What is "the rate specified in the plan" in section 415(b)(2)(E)(iii) with respect to a particular individual in the following situations:

(1) the plan does not suspend benefit payments in accordance with section 203(a)(3)(B) of ERISA; it actuarially increases each

participant's entire accrued benefit for late retirement using a 6 percent interest rate, but the individual receives no net benefit from the increases because they are offset against his additional accruals after normal retirement age;

(2) the plan suspends benefit payments in accordance with section 203(a)(3)(B) of ERISA; it actuarially increases each participant's accrued benefit at normal retirement age for late retirement using a 6 percent interest rate, as permitted by Prop. Treas. Reg. § 1.411(b)-2(b)(4)(iii)(B), but the individual receives no net benefit from the increases because they are offset against his additional accruals after normal retirement age;

(3) the plan suspends benefit payments in accordance with section 203(a)(3)(B) of ERISA; it actuarially increases the benefit of any participant who works in circumstances that do not constitute section 203(a)(3)(B) service for late retirement using a 6 percent interest rate, but the individual's benefit is not increased because he works in circumstances that do constitute section 203(a)(3)(B) service.

Proposed Answer: In each of these situations, "the rate specified in the plan" in section 415(b)(2)(E)(iii) with respect to the individual is 6 percent. According to IRS guidance, "the rate specified in the plan" is "the interest rate . . . used for [determining] actuarial equivalence for late retirement benefits under the plan." Rev. Rul. 95-29, Q&A-8, 1995-1 C.B. 81; see Notice 83-10, Q&A G-4, 1983-1 C.B. 536. It is irrelevant that, because of the individual's particular circumstances, he does not receive any net benefit from the actuarial adjustments otherwise provided under the plan.

IRS Response: The IRS agrees with the proposed answer for the first two situations. The rate specified in the plan is the rate used for making late retirement adjustments under the plan. In the third section, the plan only adjusts benefits in narrow situations, and the IRS is not ready to indicate whether the rate in the example is the rate specified in the plan for 415 purposes.

31. §417(c) - QPSA Benefits

A QPSA must be calculated at the employee's earliest retirement age. Reg. 1.401(a)-20, Q&A 19 indicates that the plan must make reasonable actuarial adjustments to reflect a payment earlier or later than the earliest retirement age. How is this requirement to be interpreted in the following situations? Assume for all questions that on the date of death the participant had accrued a monthly benefit of \$1,000 payable at normal retirement age, the QPSA provides a spousal benefit equal to the benefit that the participant had accrued, and the spouse defers commencement of the QPSA benefit.

- A plan only has one set of actuarial reduction factors for commencement of benefits prior to normal retirement age. Those factors reduce benefits 5/9ths for each month benefits commence prior to age 65 and 5/18ths for each additional month benefits commence prior to age 60. What is the benefit payable when the participant would have attained age 60? Age 65?
- A plan has different sets of factors for terminated vested participants and early retirees. Terminated vested participants receive a reduction of 5% for each year prior to age 65 that benefits commence. Participants who attain age 55 with 10 years of service while employed receive a reduction of 2% for each year prior to age 65 that benefits commence. The participant dies at age 54. What is the benefit payable when the participant would have attained age 60? Age 65?
- Same as above, except that the participant dies immediately after qualifying for the subsidized early retirement reduction factors. What is the benefit payable when the participant would have attained age 60? Age 65?

Proposed Answer: The requirement that a QPSA be adjusted to reflect a payment earlier or later than normal retirement age merely requires that the appropriate set of actuarial factors be determined at the date of the participant's death. Payment is then determined using that set of factors as if benefits were commencing for the participant. To do otherwise would grant the surviving spouse greater rights and benefits than that accrued by participant, something not required by §417. Accordingly, the answers to the above situations are as follows.

- When the participant would have attained age 60, the spouse is entitled to a monthly benefit of \$667 (\$1,000 reduced by $1/3$ ($60 \times 5/9$)). At age 65, the spouse is entitled to a monthly benefit of \$1,000.
- When the participant would have attained age 60, the spouse is entitled to a monthly benefit of \$750 (\$1,000 reduced by 25% ($5\% \times 10$ years)). At age 65, the spouse is entitled to a monthly benefit of \$1,000.

- When the participant would have attained age 60, the spouse is entitled to a monthly benefit of \$900 (\$1,000 reduced by 10% (2% x 10 years)). At age 65, the spouse is entitled to a monthly benefit of \$1,000.

IRS Response: The IRS assumes the plan has no early retirement available before age 55 and in the first two situations, the participant dies at age 54. With those assumptions, the IRS refrained from answering the first two situations in the proposed answer, because it was not willing to vouch for whether the reduction factors used by the plan are actuarial equivalence. First, the plan calculates the amount available at the earliest retirement age or death, and adjust those benefits. Under the third situation, the spouse would be entitled to something greater than the amounts specified in the proposed answer. This is the case even though if the participant had died at age 65, the spouse would only have been entitled to a benefit of \$1,000. The value of an early retirement subsidy must be reflected in any later commencement of distribution to the surviving spouse. The IRS acknowledged that this requires the plan to treat the surviving spouse better than it treats the participant.

32. §419A(d) - Welfare Benefit Fund

What amount must be charged to a key employee's separate account under section 419A(d) to reflect coverage and benefits provided to the individual under a self-insured retiree medical plan?

Proposed Answer: A reasonable estimate of the cost or value of the coverage under the plan. See the DEFRA Blue Book at 787 ("The amount to be charged against a key employee's account when benefits are provided is to be determined under Treasury regulations. The Congress intended that these regulations will provide for the computation of the amount on the basis of a reasonable estimate of the value of the key employee's coverage under a plan."); Treas. Reg. § 54.4976-1T, Q&A-2 (excise tax applies to retiree health benefit if "the cost for such coverage is not charged against or paid from such separate account").

IRS Response: The IRS agrees with the proposed answer.

33. §422 - Incentive Stock Option Plans

Assume that a corporation adopts an ISO plan on November 1, 1996, with an effective date of January 1, 1997. Assume shareholder approval is obtained on March 1, 1997. Proposed Treasury Regulation Section 1.422A-2(c) provides that the plan must expire ten years from the earlier of when the plan is adopted or when shareholder approval is obtained. Must the ten years be measured from November 1, even though the plan did not become effective until January 1?

Proposed Answer. The ten year period should begin on January 1, when the plan became effective. Prior approval should not have any effect.

IRS Response: The IRS disagrees with the proposed answer. The regulations use the date that is the earlier of adoption or shareholder approval, and that should be November 1, 1997 in this example.

34. §422 - Incentive Stock Options

Can an SAR be added after the grant of an Incentive Stock Option, or does that constitute a modification?

Proposed Answer. Yes, as long as the terms of the SAR are such that it could have been granted with the original ISO.

IRS Response: The IRS agrees with the proposed answer. The SAR is a modification of the ISO. See §424(h).

35. §4978 - Excise Tax on Certain Dispositions of ESOP Stock

Assume that an ESOP receives a QDRO within three years of a transaction to which Section 1042 applies. Would the excise tax under Section 4978 apply to the distribution of the shares to the alternate payee?

Proposed Answer. Yes. Although inequitable, there is no exception in Section 4978.

IRS Response: The IRS agrees with the proposed answer. If there is a disposition of the stock without an exception, there is an excise tax.

36. §7805(b) - APRSC.

Assume an employer undertakes a self-audit of its qualified plan and discovers operational violations which the employer corrects under the Administrative Policy Regarding Self Correction (APRSC). If the plan is subsequently audited, is the employer required to turn over to the IRS auditor the employer's internal reports prepared in connection with the employer's self-audit?

APRSC was announced in December 1996 as a method of permitting field agents and their managers greater discretion in settling plan audits. However, if an employer takes the required self-examination steps as required by APRSC, it seems unfair for the IRS agent to use the employer's internal report as the basis for discovering operational violations, since this would be the equivalent of giving the IRS auditor a "road map" of the plan's problems.

Proposed Answer: The IRS auditors should be permitted to have access to the documents showing that the employer used APRSC to correct the identified defects but the IRS auditors should not have access to the "back-up" reports prepared by the employer in its self-audit of the plan, unless the employer elects to make such reports available to the IRS auditor.

IRS Response: The IRS has the power to ask for books and records, but APRSC is intended to encourage self-examination and self-correction. The IRS indicated the agent is not going to ask for self-audit papers. If a defect is found, however, the employer may want to provide the documents to indicate the correction has been made.

37. §9801(e) - Certificate of Creditable Coverage.

Is an employer required to give a certificate of creditable coverage to employees who terminated employment with the employer between July 1, 1996 and July 1, 1997?

Under the Health Insurance Portability and Accessibility Act, an employer must provide a certificate of creditable coverage to employees beginning July 1, 1997. The data required to be included on the certificate must be from October 1996 (or July 1996, if the participant so requests in writing). It is unclear whether employers must provide employees who terminated employment before July 1, 1997 with a certificate of creditable coverage.

Proposed Answer: Employers must only give certificates of creditable coverage to those employees who terminate employment on or after July 1, 1997.

IRS Response: The IRS disagrees with the proposed answer. The regulations issued last month indicate certification is due for automatic events occurring after October 1, 1996, though the certification does not have to be provided until June 1997. The employer is also allowed to use a notice in lieu of the certificate for pre-June automatic events, but the certificate has to be provided upon request.