Joint Committee on Employee Benefits Q&A
with the Internal Revenue Service and
U.S. Department of Treasury
based on a meeting with staff
May 11, 2002

The following questions and answers are based on informal discussions between private sector representatives of the JCEB and Treasury Department and IRS officials. The questions were submitted by ABA members, and the responses were given at a meeting of JCEB and government representatives. The responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the discussions was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting, and has not been reviewed by IRS or Treasury. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.

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1. §72(t) – Early Distribution Penalty Tax

Is the relief from the early distribution tax on qualified plan distributions provided by §72(t)(2)(v) still limited to employees incurring a separation from service after age 55 or is such relief now available to employees incurring a severance from employment, within the meaning of §401(k)(2)(B)(I), as amended by EGTRRA?

Proposed response: Based on recent legislation, it appears that Congress intended the severance from employment standard to apply to the definition of a distributable event under §401(k), but not to the taxation of distributions. In addition to not amending §72(t)(2)(A)(v) at the time that §401(k)(2)(B)(i)(I) was amended by EGTRRA, Congress did not to make a technical correction to §72(t)(2)(A)(v) as part of the recent Job Creation and Worker Assistance Act of 2002 (the "JCWA"), which made a similar technical correction to §613 of EGTRRA. (See §411(k) of the JCWA, replacing the requirement under the top heavy look back rule of §416(g)(3)(B) for a "separation from service" with a "severance of employment".

IRS response: The IRS agrees with the proposed response. The IRS interprets the phrases “separation from service” and “severance from employment” as having different meanings. Where separation from service is retained in the statute, the standard has not changed.

2. §125 – Cafeteria Plan

An employee terminated in March and had already been a participant in the cafeteria plan but hadn't used up her entire medical expense account. This employee was rehired in October. The plan document states that she cannot reenter the plan until the next plan year, which starts on January 1. Can she use the money that is still in her medical expense account for claims she incurs after her rehire date?

Proposed response: No. Contributions for one period of coverage cannot be used to reimburse the participant for expenses incurred during another period of coverage, even if they are in the same plan year.

IRS response: The IRS agrees with the proposed response.

3. §125 – Cafeteria Plans

Is the procedure to harvest stem cells reimbursable through a participant's medical reimbursement account? The employee's wife is pregnant, and they are looking into the procedure as an option to use the cells if anything should be wrong with their child after it is born.

Proposed response: Yes. This is analogous to an employee's contributing blood (for use in a possible transfusion) in advance of a surgery.

IRS response: The IRS agrees with the proposed response, if the expenses are for medical care under section 213. If the expense is not a medical expense under section 213, the expense is not reimbursable. The IRS officials present noted neither they nor their offices interpret whether expenses are medical expenses under section 213.

4. §132(f) – Qualified Transportation Fringe Benefits

An employee pays for parking on her employer's premises on a pre-tax basis. The employee is charged monthly for her parking space, and must pay each month in order to hold the space. The employee does not actually park in her parking space every day. For example, the employee may be out sick, on vacation, or out-of-town. Is the entire month's parking fee considered a qualified parking expense? Does the answer change if the employee is out for longer than a month (for example, on military or short-term disability leave), but continues to pay the monthly charge to hold her space?

Proposed response: The entire monthly charge is a qualified parking expense, even if the employee does not actually park in the space every day. The employee has incurred the expense, and is using the space, either to park in or to hold the space. The charge would not be a qualified parking expense if (1) the individual ceases to be an employee, or (2) the employee has paid on behalf of someone else who is actually parking in the space. The length of the leave does not matter, as long as the individual remains an employee.

IRS response: The IRS agrees with the proposed response, but noted that if the employee pays the expense on behalf of someone else, it is no longer a qualified parking expense regardless of whether the other person actually used the space.

5. §401(a) –General Qualification Requirements

What are the limits of the tax-qualification requirement that a plan be administered in accordance with its terms. For example, some plans incorporate by reference a plan's QDRO procedures, loan procedures, or hardship withdrawal procedures. In such a case, if the applicable procedures were not followed exactly, would the plan be disqualified? Similarly, if a plan's administrative rules were not followed (e.g., the plan provided that the Committee's internal procedures should be consistent with the corporation's bylaws, and an action taken by the Committee was inconsistent with the bylaws), would that disqualify the plan?

Proposed response: In none of these instances should a plan be disqualified, because the relationship to the definitely determinable benefit rule is too tenuous.

IRS response: The IRS disagrees with the proposed response. This is not a definitely determinable benefit issue, but the plan operation must follow the terms of the plan document, regardless of whether the plan provision concerns a specific qualification requirement. The IRS noted it is not always clear what is a plan document, but also noted that DOL has an expansive view of what constitutes a plan document. The IRS definition may not bring in all other documents associated with the plan, but usually looks at what is submitted for a determination letter.

6. §401(a)(4) – New Comparability Regulations

Do the new comparability regulations apply for purposes of the average benefits percentage test? Assume an employer sponsors both a defined benefit and defined contribution plan, each of which is tested for coverage and nondiscrimination separately, but uses the average benefits test for demonstrating compliance with the coverage requirements for one or both plans. Do the new comparability regulations affect the employer's ability to do the average benefits percentage test on a benefits basis?

Proposed response: The new comparability regulations do apply for purposes of the average benefits percentage test, but won't restrict the employer's ability to do the test on a benefits basis in the situation described. Treas. Reg. 1.410(b)-5(d)(5) indicates that the employee benefit percentage for the average benefits percentage test is "the rate that would be determined for that employee for purposes of applying the general test for nondiscrimination in Treas. Reg. 1.401(a)(4)-2, 1.401(a)(4)-3, 1.401(a)(4)-8 or 1.401(a)(4)-9, if all the plans in the testing group were aggregated for purposes of §410(b)." Since the new comparability regulation provisions in Treas. Reg. 1.401(a)(4)-8 and 1.401(a)(4)-9 affect the rate that would be determined for the general nondiscrimination test, those provisions apply for purposes of the average benefits percentage test.

However, in the case of an employer sponsoring a defined benefit plan and a defined contribution plan that are tested separately under the coverage and nondiscrimination regulations, except that benefits under both plans are considered for purposes of the average benefits percentage test, the defined contribution plan will satisfy Treas. Reg. 1.401(a)(4)-9(b)(2)(v)(C), the "broadly available separate plan" threshold. The average benefits percentage test in this situation can be determined on a benefits basis.

IRS response: The IRS agrees with the proposed response.

7. §401(a)(4) – High 25 Employee Distribution Restrictions

Can a plan pay a subsidized early retirement annuity benefit to a restricted employee, or must the value of the subsidy be stripped out?

Proposed response: A plan can pay a subsidized early retirement annuity benefit to a restricted employee without obtaining a security agreement or violating the distribution restrictions on the 25 highest paid employees. Treas. Reg. 1.401(a)(4)-5(b)(3)(i) indicates that the payment of benefits to or on behalf of a restricted employee cannot exceed, *inter alia*, "a straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the restricted employee is entitled under the plan." While the regulation defines who are restricted employees and what benefits are restricted, it does not define actuarial equivalence. If the plan provides an early retirement subsidy for annuity benefits to some or all participants, the value of that subsidy can be included in determining the actuarial equivalence of the benefit payable to the accrued benefit.

IRS response: The IRS agrees with the proposed response. The policy behind the distribution restrictions is to prevent a "run on the bank" through lump sum distributions. As long as the early retirement subsidy is being paid out in an annuity benefit, there's no undue depletion of the plan assets and the distribution is permitted.

8. §401(a)(17) – Compensation Limitation

Can the increase in the allowable compensation limit enacted by EGTRRA be applied to former employees, in the same manner that the benefit increase under §415(b) can be applied?

Proposed response: Yes. Such an increase in benefits for former employees would have to satisfy the §415(b) limitation on benefits and would have to satisfy the nondiscrimination standards for accrual of benefits by former employees under Treas. Reg. 1.401(a)(4)-10. While application of the increase in the compensation limit to former employees would result in an accrual of benefits solely by former HCEs, such an accrual might not result in significant discrimination in favor of HCEs. Application of the increase in the limit could be considered as the removal of a prior benefit limitation that only applied to such employees.

IRS response: The IRS agrees with the proposed response. For nondiscrimination testing of accruals by former employees, you can test only on the basis of current accruals, in which case retroactive application of the compensation limit increase would result in benefit accruals only by former HCEs. However, a plan can also test former employees on the basis of total benefits, with the increased compensation limit also being used to determine accrual rates, which should greatly increase the chances of passing the nondiscrimination test.

9. §401(a)(28) – ESOP Diversification Rights

Notice 88-56 provides that the diversification requirement of §401(a)(28) is satisfied if a plan "has made available" to a qualified participant a distribution of a portion of the participant's account, without regard to whether a qualified participant actually receives a distribution. By what means may a plan sponsor satisfy the availability requirement? Will a summary plan description suffice, or must the requirement be satisfied annually? Assuming that notification must be provided annually, in what fashion can the failure to provide such notification be corrected? Is a plan sponsor required to assume that a participant would have diversified his account in the most advantageous manner?

Proposed response: The availability requirement can be satisfied by any reasonable means of notifying plan participants, and need not be provided annually. If no notice is provided, there is no requirement that the correction methodology must assume a participant would have made the most advantageous transfer of funds.

IRS response: The IRS disagrees with the proposed response. A qualified participant must be offered a diversification election annually. The SPD description generally is not sufficient. If notice is not provided and the value of the stock declines, the employer must true up the participant's account, with earnings, to reflect the lost value of the stock.

10. §401(k) – Cash or Deferred Arrangement

Can §401(k) plans still be tested using the §410(b)(4) otherwise excludable employee rule?

Proposed response: Yes. §401(k)(3)(F), enacted by the Small Business Job Protection Act of 1996, provides that a §401(k) plan with less restrictive age and service eligibility may perform the ADP test by including any HCEs with less than a year of service or under age 21 in the test for employees that satisfy the 21 and 1 conditions. However, this method is not mandatory and a plan may, in the alternative, perform separate ADP tests on the two different populations, with any HCEs who do not satisfy the minimum age and service eligibility conditions being tested with the other employees who do not satisfy such conditions.

IRS response: The IRS agrees with the proposed response.

11. §401(k) – Cash or Deferred Arrangements

A §401(k) plan offers a participant loan program with payroll deduction repayment only. If the amount of the loan repayment and the participant's elective deferral into the §401(k) plan is larger than the participant's earnings per payroll period, less other items (e.g., FICA, FUTA, income tax withholding), the plan requires the participant to cease elective deferrals until the loan is repaid. Does this practice violate the contingent benefit rule?

Proposed response: Yes. Affected participants are forced to choose between taking a plan loan or making elective deferrals. Their ability to make elective deferrals is contingent on their not taking out a plan loan.

IRS response: The IRS agrees with the proposed response. The participant must be allowed to continue making deferrals. If there are insufficient earnings to fund the deferrals and the loan repayment, the loan will likely default. Of course, the participant can decide to voluntarily cease deferrals in order to avoid loan default.

12. §401(k) – Cash or Deferred Arrangements

Under sections V.A and VI.A of Notice 98-52, cash or deferred arrangements and defined contribution plans have to satisfy the safe harbor for an entire 12-month plan year. Thus, if an existing CODA is changed to a safe harbor plan, it must be amended as of the beginning of a new plan year. It is not clear, however, what happens if a non-safe harbor contribution attributable to the preceding plan year is actually paid into the plan in the new year (simply because the final pay period for the plan year overlaps into the new plan year). In such a case, is it still possible under Notice 98-52 for the amended plan to satisfy the safe harbor contribution requirement "for the entire plan year?"

Proposed response: The rule should permit a plan to satisfy the safe harbor, provided that it satisfies the safe harbor with respect to all pay periods that begin in a 12-month plan year, even if some testing has to be done with respect to overlapping elective or matching contributions from a previous year, or with respect to employee after tax contributions under Treas. Reg. 1.401(m)-1(b)(4)(i).

IRS response: The IRS agrees with the proposed response, assuming the contribution is made within the time period for treating the contribution as a §415 annual addition for the year.

13. §401(k) – Hardship Distribution

How soon after incurring the financial hardship must the participant request a distribution? Note that in some cases, it may not be readily apparent when the participant must pay the bills that cause the hardship. For example, a participant injured in a car accident may not know whether or not his medical expenses will be covered by insurance or whether the participant will ultimately receive a recovery from another party that covers the expenses.

Proposed response: No bright-line tests are available. This is a matter that will have to be decided in the judgment of the fiduciary of the plan.

IRS response: The IRS agrees with the proposed response. The distribution is subject to the plan’s written hardship distribution procedures.

14. §401(k) – Hardship Distributions

Participant took out a hardship distribution, cashed the check, paid the taxes and penalties. She took the distribution to use towards a down payment of a primary residence and the closing fell through. Now she would like to redeposit the money into the plan and have the taxes credited back to her account. Does this work?

Proposed response: Yes. The participant may re-contribute the amounts to the plan.

IRS response: The IRS disagrees with the proposed response. The only way for the participant to re-contribute the distribution to the plan would be through a rollover back into the plan, and a hardship distribution cannot be rolled over. When the distribution was made from the plan it was a hardship distribution, and the subsequent change in events does not re-characterize the distribution.

15. §401(m) – Employee After-tax Contributions

A defined benefit plan currently requires employees to elect to make after-tax contributions in order to participate in the plan. Can the sponsor amend the plan to provide for negative enrollments? Under the negative enrollment process, employees would be required to make the mandatory after-tax contributions unless they affirmatively elected to waive plan participation.

Proposed response: The plan can provide for either affirmative enrollments (eligible employees must elect to participate) or negative enrollments (eligible employees are automatically enrolled unless they elect to waive participation). Because contributions are after-tax, neither arrangement will constitute a cash-or-deferred arrangement. In addition, the contributions will be considered "mandatory contributions" for purposes of the §415 limits.

IRS response: The IRS agrees with the proposed response, including that the automatic enrollment will not change the tax treatment or §415 application of the contribution.

16. §402 – Qualified Plan Distributions

If two people are participants in the same qualified retirement plan, and one is the 100% beneficiary of the other, can the participant's account balance simply be transferred to the beneficiary's account balance upon the death of the participant (assuming that is what the beneficiary elects)?

Proposed response: Yes. There is no need to have a distribution and re-contribution of the funds.

IRS response: The IRS disagrees with the proposed response. The benefit can be transferred to the beneficiary under the rollover rules, including as a direct rollover, if the distribution can be rolled over under §402(c). If the beneficiary is a surviving spouse, the distribution may be rolled over into a plan, but not if it is a non-spousal beneficiary.

17. §410(b) – Minimum Coverage Requirements

Can a plan be tested under the otherwise excludable employee rule excluding employees with less than the maximum age or service under the plan eligibility provisions?

Proposed response: Yes. Treas. Reg. 1.410(b)-6(b)(3) indicates that the effect of the otherwise excludable employee rule is that "employees who would be excludable . . .but for the fact that the plan does not apply the *greatest* permissible minimum age and service conditions may be treated as excludable employees with respect to the plan." [emphasis added] The reference to the greatest permissible age and service conditions necessarily includes age and service conditions of lesser magnitude. A plan that allows employees to participate on date of hire can test for coverage treating employees who would not satisfy a 3 month or 6 month, for example, service requirement, not just a 1 year service requirement.

IRS response: The IRS disagrees with the proposed response. The otherwise excludable employees must be defined by reference to the maximum age and service limits, not a lesser standard.

18. §411 – Vesting Service

An employer has an over-funded defined benefit plan where benefit accruals have been frozen since 1986. This is not a terminated plan. The employer would like to start a new cash balance plan with cash balance credits that begin January 1, 2002. However, providing the cash balance accruals under the frozen DB plan (without any conversion of the frozen plan benefits to cash balance accounts) offers the advantage of using the frozen plan over-funding to pay for future cash balance plan accruals.

The employer would like to disregard service prior to January 1, 2002 for purposes of vesting benefit service. Can the employer disregard the pre-2002 service on the grounds that the plan was not maintained prior to then with regard to the future cash balance accruals? If not, could the employer achieve the desired results by starting a completely separate cash balance plan and soon thereafter merging it into the frozen plan?

Proposed response: Assuming that the employer granted full vesting to participants when the initial DB plan was frozen and there have been no contributions to the plan since the freeze date, then prior vesting service credit could be limited as follows:

1. Employees who were never covered under the frozen prior plan would not have to receive vesting credit for service prior to commencement of the cash balance plan on January 1, 2002.
2. Employees who were covered under the frozen plan would have to receive credit for service before that plan was frozen.
3. However, employees do not have to be credited with the service between the freeze date up to January 1, 2002.

Service for periods during which the plan is not maintained does not have to be counted, as stated by §411(a)(4)(C). For this purpose, the frozen plan was not maintained between the date the original plan was frozen in 1986 and January 1, 2002.

According to Treas. Reg. 1.411(a)(2)(iii):

> (iii) Period after termination or withdrawal. The period for which a plan is not maintained by an employer includes the period after the plan is terminated. For purposes of this section, a plan is terminated at the date there is a termination of the plan within the meaning of §411(d)(3)(A) and the regulations thereunder. Notwithstanding the preceding sentence, if contributions to or under a plan are made after termination, the plan is treated as being maintained until such contributions cease, whether or not accruals are made after such termination.

The subparagraph above refers to §411(d)(3)(A), which reads as follows:

> (3) TERMINATION OR PARTIAL TERMINATION; DISCONTINUANCE OF CONTRIBUTIONS - Notwithstanding the provisions of subsection (a), a trust shall not constitute a qualified trust under §401(a) unless the plan of which such trust is a part provides that -
>
> (A) upon its termination or partial termination. . .

The frozen plan was in a partially terminated status after the freeze date. For purposes of vesting service credit, as long as the employer did not make contributions to the plan after the freeze date, the employees' service would not have to be taken into account.

IRS response: The IRS disagrees with the proposed response. The IRS considers the partial termination issue a non-issue in this situation. The employer was maintaining a plan during the entire period described above and vesting service must be credited for that period.

19. §411(d)(6) – Anti-cutback Rule

Rev. Rul. 2001-62 provides a new mortality table for use under §417(e). The holding indicates that "a plan amendment will not violate §411(d)(6)(B) and the corresponding provision of ERISA solely because of a reduction in any annuity distribution with an annuity starting date on or after the later of the adoption date or the effective date of this amendment if the cause of such reduction is the substitution of the table in this revenue ruling for the table in Rev. Rul. 95-6." Does this provision apply for purposes of determining annuity benefits under cash balance defined benefit plans?

Proposed response: Yes, the relief extends to the determination of any annuity benefit under any type of defined benefit plan. A cash balance or other hybrid defined benefit plan can adopt the new mortality table for determining annuity benefits without providing a grandfathered minimum annuity benefit.

IRS response: The IRS agrees with the proposed response.

20. §411(d)(6) – Anti-cutback rule

Assume a discretionary profit sharing plan (or a §401(k) plan) does not have a 1,000 hour or last day of the plan year requirement. Is there an anti-cutback problem if the plan is amended mid year to:

- increase the annual compensation limit to $200,000 (contribution allocated on a pro rata basis)
- change the vesting schedule to provide for faster vesting for matching contributions (thereby reducing the amount of forfeitures to be allocated for the year)
- increase the annual compensation limit to $200,000 in a §401(k) plan resulting in the plan passing the ADP test.

Assume a discretionary profit sharing plan has a last day of the plan year requirement but the requirement does not apply to participants who retire, die or become disabled during the plan year. The plan is amended mid year to increase the compensation limit to $200,000. Is there an anti-cutback issue with respect to the participant who retires, dies or becomes disabled prior to the adoption of the amendment?

Proposed response: In a discretionary profit sharing plan there is no anti-cutback issue regardless of whether there is a last day of the plan year requirement. A participant does not accrue a protected benefit until the contribution is actually made to the plan and the participant has met any other requirements imposed by the plan (such as an hour requirement).

In TAM 9735001 a discretionary profit sharing plan's allocation formula was retroactively amended after the end of the plan year and after a contribution had been made to the plan but before the due date of the employer tax return. The IRS concluded that the retroactive amendment of the formula violated §411(d)(6). The facts presented in the TAM are different from the facts outlined above where the plan is being amended mid year (or in any event by the last day of the plan year) and therefore a similar conclusion should not be applied to the above facts. Moreover it is our understanding that:

- this TAM is currently under reconsideration;
- the IRS has orally agreed not to challenge anti-cutback issues regarding changes in a discretionary profit sharing plan formula prior to the reconsideration being complete and the IRS issuing something in writing;
- the IRS will not challenge the §411(d)(6) cutback issue regarding EGTRRA amendments for 2002 and that no amendments (with respect to the compensation limit increase or the faster vesting for matching contributions) needed to be in place by the end of 2001 to be effective for the 2002 plan year.

IRS response: The IRS agrees with the portion of proposed response that it will not challenge the §411(d)(6) cutback issue regarding EGTRRA amendments for 2002 and that no amendments (with respect to the compensation limit increase or the faster vesting for matching contributions) needed to be in place by the end of 2001 to be effective for the 2002 plan year. Rev. Proc. 2001-42 establishes an amendment procedure for plan amendments, but mandatory and discretionary amendments, allowing plan sponsors until the end of the 2002 plan year to adopt good faith amendments. Specific §411(d)(6) relief is provided for top heavy plans in that procedure. The IRS disagrees with the portion of proposed response that the TAM is under reconsideration or that it has orally agreed not challenge anything.

21. §411(d)(6) and §412(c)(8) – Anti-cutback Rule

Can a lump sum payment option under a defined benefit pension plan be eliminated with respect to benefits already accrued under the plan in the event of substantial business hardship (Chapter 11 proceeding) of the plan sponsor with the consent and approval of the IRS pursuant to Treas. Reg. §1.411(d)-4/ Q-2 and §412(c)(8)?

Proposed response: Sections 411(d)(6) and 412(c)(8) were enacted in 1974, but the original language of §411(d) simply said that a company could not retroactively reduce an accrued benefit, except as provided in §412(c). In 1974 the term "accrued benefit" meant the amount of one's monthly pension (the provision to protect optional forms of benefit was added ten years later in 1984).

Section 412(c) needs to be read in that light. Section 412(c) is a part of the statute that deals with adequate funding of pension plans; §412(c)(8) permits a company (with the consent of the DOL) to retroactively reduce one's accrued benefit (the actual pension amount) to what it was at the beginning of the year if the amendment is made within 2 1/2 months after the end of the year. The limitation on the retroactive effect makes sense in the context of the relief available under §412 (company can't meet minimum funding standard for the year). However, §411(d)(6) was amended in 1984 to protect optional forms of benefit (such as a lump sum payment). Section 411(d)(6) was amended to say that a plan amendment that eliminated an option form of benefit is treated as an amendment that reduces an accrued benefit (Note: the Code does not define the term "accrued benefit" to include the optional form of benefit) ; no change was made to §412(c)(8). Some people read the language of §412(c)(8) which says one can't reduce the "accrued benefit...determined as of the beginning of the plan year to which the amendment applies" to mean one can't eliminate the lump sum with respect to benefits accrued before that time. The two sections should be read together to permit the elimination of the lump sum option with the consent of the DOL (now IRS) as long as the amount of the monthly pension is protected. The limitation on retroactive application of the amendment to the preceding years accrual must apply to the amount of the accrued benefit only because one can not eliminate a lump sum option that has already been paid.

IRS response: The IRS disagrees with the proposed response. The right to eliminate benefit accruals under §412(c)(8) does not include the right to eliminate optional forms of benefit. If the lump sum were added to the plan during the period covered by §412(c)(8) (i.e., the prior plan year), it may be possible to eliminate the lump sum distribution option in that circumstance.

22. §414(i) – Defined Contribution Plan

A company closed operations and proceeded to effect distributions of all accounts under its DC plan to its former employees, all of whom had a termination of employment. The distribution election forms clearly stated that account balances would be credited with interest through June 30 and any earnings thereafter would be prorated among any accounts remaining under the plan. Election forms were returned and all accounts under the plan were paid out with earnings through June 30. The actual distribution of all accounts occurred August 31. The trustee did not place the assets in a non-interest bearing account as of June 30. The plan stated that administration costs could be assessed to the plan but the company paid those costs. Who is entitled to the interest earned between June 30 and August 31 - the plan participants or the company?

Proposed response: All of the participants received their account balances as of June 30, which is what they were entitled to under the terms of the plan and the distribution election forms. Accordingly, it should be permissible for the plan to reimburse the company for its prior payments of plan expenses (without interest), assuming the expenses were necessary and reasonable for the administration of the plan. Reimbursement of the company should be allowed under ERISA §408(b)(2).

IRS response: The IRS disagrees with the proposed response. A defined contribution plan must credit interest while there is an account under the plan. The IRS expressed potential concern about having an artificial cut-off date for crediting interest, but noted that during the DOL Q&A session, the DOL viewed such a provision as benign. The IRS also noted that reimbursing the employer for expenses should be limited to current expenses, but declined to define what expenses would be considered current.

23. §414(v) – Catch-up contributions

Must a §401(k) plan that offers the ability to make catch-up contributions and uses the safe harbor hardship withdrawal suspension rule of Treas. Reg. 1.401(k)-1(d)(2)(iv)(B)(4) also suspend catch-up contributions? Does this suspension violate the "universal availability" requirement of §414(v)?

Proposed response: A §401(k) plan that uses the safe harbor withdrawal suspension rules must also suspend catch-up contributions for the applicable suspension period. (See §414(v)(1) and Prop. Treas. Reg §1.414(v)-1((a)(1), which define catch-up contributions as additional elective deferrals.) Such suspension does not violate the universal availability requirement. §414(v)(4)(A) is intended to make sure availability of making catch-up contributions does not violate the general nondiscrimination requirements of §401(a)(4). The suspension rules do not violate the nondiscrimination rules of §401(a)(4) so, consistent with the intent of suspending contributions on hardship withdrawal, such suspension does not violate the universal availability requirement.

IRS response: The IRS agrees with the proposed response. If the participant cannot defer, no need to make a catch-up contribution. In order to make catch-up contributions, the participant must be able to make elective deferrals.

24. §414(v) – Catch-up Contributions

Suppose for 2006, an employee (age 50+) worked for two unrelated employers, earning $100,000 for each employer for $200,000 total annual compensation. Employee defers 10% / $10,000 in Plan A, 10% / $10,000 in Plan B, for a $20,000 total deferral.

For §402(g) purposes, the maximum deferral limit is $15,000, plus $5,000 of catch-up contributions, so there's no violation. Both employers have experienced ADP testing issues and limit executives to only 5%. (Assume employee is a 5% owner of the second employer, since that's the only way an employee can be a highly compensated employee in the initial year of employment).

Is it permitted for the employee to have $5,000 of deferrals in Plan A and another $5,000 of deferrals in Plan B to be treated because of the ADP test?

Proposed response: Yes, the employee can have only $5,000 in deferrals for each of the unrelated employers because only the deferral limit of §402(g) is aggregated at the employee level, not plan limits such as the ADP test.

IRS response: The IRS agrees with the proposed response, noting that elective deferrals are not aggregated across unrelated employers, other than the application of the §402(g) limit, which is applicable to the individual employee regardless of the employer.

25. §414(v) – Catch-up contributions

Within a given plan, for a plan sponsor that allows catch-up eligible employees to put in $12,000 and others to put in $11,000 pre-tax, what (if any) sort of discrimination testing will be required with respect to catch-up contributions?

Proposed response: Whether it is discriminatory or not would depend on the "normal" benefits, rights, features issues, such as (a) how high your maximum contribution rate is, and (b) the demographic profile (pay, etc.) of your catch-up contribution eligible employees.

For example, for a plan sponsor that allows pre-tax contributions of up to 40%, virtually everyone who wants to put in this much can also get to $12,000 (in other words, their annual pay is at least $30,000).

However, if a plan sponsor only allowed a 10% maximum contribution rate, then mainly HCE's would be able to put in $12,000 (in 2002) instead of $11,000.

IRS response: The IRS agrees with the proposed response. If the employer has any other §401(k) plans, the universal availability standard would require those other plans to provide for catch-up contributions.

26. §414(v) – Catch-up contributions

An employer maintains a qualified cash or deferred arrangement on a calendar-year basis and stops all further contributions once a participant's compensation exceeds the §401(a)(17) compensation limit. If the employer institutes catch-up contributions during the third quarter of 2002, will participants whose compensation exceeded $200,000 prior to that time (and thus had all further contributions cease), be able to make catch-up contributions during the remainder of 2002?

Proposed response: The introduction of catch-up contributions to the plan constitutes the institution of a new type of contribution. Therefore, even participants whose compensation exceeded the §401(a)(17) limit prior to the availability of catch-up contributions can make such contributions to the plan during the remainder of 2002.

IRS response: The IRS agrees with the proposed response. The IRS noted that such a limit on deferrals would be considered an employer-provided limit, since neither §401(a)(17) nor the regulations thereunder would require suspending elective deferrals solely because the participant has received wages equaling or exceeding $200,000. This is not inconsistent with suspending catch-up contributions for a participant who has taken a hardship distribution and is therefore suspended from making contributions to the §401(k) plan. A participant who can no longer defer into the plan because of an employer-provided limit is still an eligible employee and can make catch-up contributions.

27. §422 – Incentive Stock Options

If a corporation obtains shareholder approval of an amendment to a stock option plan, does that extend the term of the plan from 10 years from the date the Board of Directors adopted the amendment or 10 years from the date of shareholder approval?

Proposed response: Just like the rules that apply to the original adoption of the plan, the 10-year duration starts from the date of the Board of Directors approval.

IRS response: The IRS disagrees with the proposed response. The 10-year period is measured from the earliest event, the adoption of the amendment or obtaining shareholder approval.

28. §423 – Employee Stock Purchase Plan

Can income recognized pursuant to an Employee Stock Purchase Plan under §423 ("ESPP") be exempt from §162(m)?

Proposed response: No. The grant must be made by the compensation committee, which is not the way that ESPPs work.

IRS response: The IRS disagrees with the proposed response. There's no reason ESPP income can't be considered performance-related compensation and therefore exempt from §162(m), but they noted that ESPP plans commonly have employee discounts from the current market price, and that would not be considered performance-related compensation.

29. §501(c)(9) – Retiree Health Reimbursement Plans.

Assume a union negotiated retiree medical reimbursement plan, which is tax exempt under §501(c)(9). The plan is funded by mandatory, non-elective contributions (either employee contributions, employer contributions, or both) during the employees' working careers, negotiated through collective bargaining. The plan pays benefits after retirement for health care related expenses. We are assuming from prior IRS rulings that the contributions are pre-tax under §451 since they are mandatory and the benefits are non-taxable under §106.

1. Is it permissible to reimburse both premiums and medical expenses, as part of the same plan, without jeopardizing the tax advantages under §§106 and 501(c)(9)?
2. Does the answer to #1 depend on whether the contributions are deposited into a plan from which every retiree gets a flat benefit (e.g., up to $250/month until Medicare age); or into a plan that pools the plan assets for investment purposes, but that maintains an individual "Employee Balance" in recordkeeping, for each employee (based on the negotiated mandatory contributions made for that employee pre-retirement), which the retiree can spend

down over time (years) as the retiree needs the money for reimbursement of medical expenses or premiums, until the Employee Balance reaches zero?

3. If the individual account model (i.e., defined contributions model) described above paid a death benefit (taxable) in the amount of the "Employee Balance" on the death of the Retiree, to a dependent of the Retiree, would any of the tax advantages under §§106 or 501(c)(9) be lost?

Proposed response:

1. YES, there is nothing to indicate that this must meet the Cafeteria Plan Rules of §125.
2. NO, it doesn't matter if it's a defined contributions or a defined benefit model.
3. NO, the plan would not be deemed a 125 plan, nor would it lose its tax-exempt status under 501(c)(9). Such a death benefit could be paid to a surviving spouse or dependent under the Code. The death benefit would not be restricted to the reimbursement of medical expenses or premiums.

IRS response: The IRS focused on proposed answer #3, and disagreed with the proposed responses. If money can be paid from the plan for reasons other than medical expenses, and in this case the plan pays a death benefit, such a payment affects the entire plan.

The preceding questions and answers are based on informal discussions between private sector representatives of the JCEB and Treasury Department and IRS officials. The questions were submitted by ABA members, and the responses were given at a meeting of JCEB and government representatives. The responses reflect the unofficial, individual views of the government participants as of the time of the discussion, and do not necessarily represent agency policy. This report on the discussions was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting, and has not been reviewed by IRS or Treasury. The questions were submitted in advance to the agency, and it was understood that this report would be made available to the public.