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COMMITTEE ON

EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS
INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

May 9, 2003

The preceding questions and answers are based on an oral presentation made by IRS and Treasury officials at the Tax Section's Employee Benefits Committee meeting on May 9, 2003. The questions were submitted by ABA members, and the responses were given at such meeting after explicit statements that their 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 responses was prepared by designated JCEB representatives, based on the notes and recollections of the JCEB representatives at the meeting and on a review of audio tapes of the meeting This report 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.

1. §72(p) – Taxation of Plan Loans

Employer maintains a defined contribution plan that provides loans to its participants. The plan provides for a sixty-day cure period for missed installment payments. An employee takes out a five-year plan loan, and fails to make his last installment payment. Would permitting the employee to cure the missed payment after the five-year term but within the cure period for the loan violate the requirement of §72(p)(2)(B)?

Proposed response: No. Curing a missed payment after the term of the plan loan but within the cure period provided by the plan and within the limitations prescribed by Treas. Reg. 1.72(p)-1, Q&A-10 would not violate the requirement of §72(p)(2)(B) of the Code. Payments made within the cure period are deemed to relate back and considered made on the day the installment payment was due.

IRS response: The IRS agrees with the proposed answer. The plan can use a cure period even at the end of the sixty-month period.

2. §79 – Group-term Life Insurance

Is a participant taxed on the premiums on group term life insurance over $50,000, even if the payment those premiums have been waived because of the insured's disability?

Proposed response: Yes. The mere fortuity that the premiums are waived does not negate the fact that the participant receives the benefit of that coverage.

IRS response: The IRS agrees with the proposed answer.

3. § 83 – Transfer of Property in Connection with Performance of Service – Split-dollar Life Insurance

The special rules in Notice 2002-8, 2002-4 I.R.B. 398, for split-dollar life insurance arrangements entered into before January 28, 2002, apply only if the sponsor "has received or is entitled to receive full repayment of all of its payments" under the arrangement. Is this requirement satisfied where, as is common, the sponsor is entitled to repayment of the lesser of the payments that it has made and the cash value of the life insurance policy?

Proposed response: Yes. The purpose of the requirement is to ensure that the only value being transferred to the insured is the increase in the cash value of the life insurance policy, i.e., future earnings. Where there is no net increase, there is no reason to impose the requirement. Furthermore, an arrangement in which the sponsor is entitled to repayment of the lesser of its payments and the cash value of the life insurance policy is economically indistinguishable from an arrangement in which the sponsor is entitled to repayment of the full amount of its payments, but this obligation is non-recourse, i.e., it is secured solely by a security interest in the life insurance policy.

IRS response: The IRS disagrees with the proposed answer. Just because there is a period of time in which the loan is underwater, when the cash value is less than the cumulative premiums, doesn't take the policy out of the loan regime.

4. §83(b) – Transfer of Property in Connection with Performance of Service

What is the effect if the person files the §83(b) election with the wrong office of the IRS?

Proposed response: Filing with the wrong office will not invalidate the filing.

IRS response: The IRS agrees with the proposed answer.

5. § 105 – Health and Medical Benefits

It is not unusual for different waiting periods to be imposed on different groups of employees before they are allowed to participate in their employer's health plan. If the plan is self-insured and some of the employees who are subject to the shorter waiting periods are highly compensated individuals ("HCIs"), does this raise an eligibility discrimination issue, a benefits discrimination issue, both or neither under § 105(h)?

Proposed response: It raises an eligibility discrimination issue, not a benefits discrimination issue. Thus, § 105(h) does not prohibit such differences as long as they do not cause the plan to violate § 105(h)(2)(A) (requirement that plan not discriminate in favor of HCIs as to eligibility to participate).

IRS response: The IRS agrees with the proposed answer.

6. §105 – Health and Medical Benefits

It is not unusual for former employees to be allowed to continue to participate in their employer's health plan for a limited period of time as if they were still active employees. Often this is done as part of a RIF or a termination agreement with a particular employee. If the plan is self-insured and some of the former employees were highly compensated individuals ("HCIs"), does this raise an eligibility discrimination issue, a benefits discrimination issue, both or neither under § 105(h)?

Proposed response: It raises an eligibility discrimination issue, not a benefits discrimination issue. Thus, § 105(h) does not prohibit such an extension of coverage as long as it does not cause the plan to violate § 105(h)(2)(A) (requirement that plan not discriminate in favor of HCIs as to eligibility to participate).

IRS response: The IRS agrees with the proposed answer, but note that providing a benefit to former employees will require that all former employees must be considered in testing for eligibility.

7. §105– Health and Medical Benefits

It is not unusual for an employer to pay COBRA premiums for former employees for a limited period of time. Often this is done as part of a RIF or a termination agreement with a particular employee. If the plan is self-insured and some of the former employees were highly compensated individuals ("HCIs"), does this raise an eligibility discrimination issue, a benefits discrimination issue, both or neither under § 105(h)?

Proposed response: It raises neither an eligibility discrimination issue nor a benefits discrimination issue as long as the premiums are treated as taxable income to the former employees, since in that case the employer's payment of the premiums is not an extension of coverage or benefits under the plan itself.

IRS response: The IRS agrees with the proposed answer.

8. §280G – Golden Parachute Payments

Is it permissible to get shareholder approval of payments for §280G purposes after the deal has closed?

Proposed response: Yes. There is no requirement that the approval be obtained before the transaction is consummated.

IRS response: The IRS agrees with the proposed answer.

9. §401(a)(4) – Nondiscrimination

Does the use of rollover proceeds to indirectly acquire a business violate nondiscrimination or other Code requirements? The situation involves an individual (Executive) who establishes a new company (Newco), which adopts a §401(k) plan. Executive is the sole director and officer of Newco. Executive rolls over to the Newco §401(k) plan funds from an eligible rollover plan. Executive then elects to invest the rollover proceeds in 100% of the stock of Newco. Newco uses the proceeds from the sale of stock directly or indirectly to acquire a target company. Once target or target's assets are acquired, new employees associated with target's business begin making §401(k) deferrals to the Newco plan, but will not have the option to direct investment in Newco stock because the offering will have closed.

Proposed response: No, the situation described does not violate any nondiscrimination or other Code requirement. The right to make particular investment choices is a benefit, right or feature. However, at the time Newco stock is available for purchase, Executive, who is Newco's sole employee and the sole participant in the plan, is not an HCE. In future years if Executive becomes an HCE, the right of Executive to continue the self-directed investment in Newco stock is not subject to the BRF requirements.

IRS response: The IRS disagrees with the proposed answer. The proposed answer discusses current availability testing with regard to the benefit, right or feature, but it doesn’t resolve the effective availability requirement, which has a timing element. The timing of the transaction appears to structure the transaction in a year where the individual is not an HCE and there may not be any other employees, but after the transaction the individual becomes an HCE. The IRS noted the fact situation may also violate the requirement that the timing of a plan amendment not discriminate in favor of HCEs. The IRS also noted its concern about investment options with inherent restrictions, such as a $100,000 minimum investment requirement. While the IRS is aware some commenters believe such inherent restrictions do not violate the nondiscrimination standards, because the investment restriction is not part of the terms of the plan, the IRS does not agree.

10. §401(a)(4) – Highest Paid 25 HCE Distribution Restrictions

In a multiple employer plan, are the restrictions in Treas. Reg. 1.401(a)(4)-5(b)(3) on the payment of lump sum amounts to the 25 highest paid highly compensated employees and former employees to be applied on an entire plan basis or are these restrictions to be applied separately to the top 25 HCEs and former HCEs of each employer sponsoring the plan?

The term "employer" is defined in Treas. Reg. 1.401(a)(4)-12, which then references Treas. Reg. 1.401(b)-9. It defines "employer" to mean the controlled group. This suggests that the restrictions would be applied separately to each employer (and the other employers in the same controlled group), rather than on an entire plan basis. However, in an analogous situation involving the same regulations, the IRS concluded that the determination should not be on a QSLOB basis. See PLR 2002248029, where the IRS determined that the QSLOB regulation does not apply to the top 25 group determination.

Proposed response: The restrictions on lump sum distributions are applied to the highest paid 25 HCEs participating in the plan, not the highest paid 25 HCEs of each plan sponsor.

IRS response: The IRS disagrees with the proposed answer. The highest paid 25 HCE distribution restrictions apply on an employer-by-employer basis. The IRS noted the QSLOB rules do not treat groups as not being part of the employer or create different controlled groups, but change certain employees' status to excludable employees.

11. §401(a)(4) – Highest Paid 25 HCE Distribution Restrictions

Does the 1% of current liability limitation under Treas. Reg. 1.401(a)(4)-5(b) apply based on the assets of the entire plan or based on each employer's portion of the total current liability. While the regulations seem to require that it be determined separately for each employer, this limitation is extremely difficult to determine in a multiple employer defined benefit plan, especially if employees transfer from time to time between employers.

Proposed response: The limitation is determined based on the plan's current liability, not the current liability associated with the employer of the employee receiving the lump sum distribution.

IRS response: The IRS agrees with the proposed answer. Current liability is determined on a plan-wide basis, not an employer-by-employer basis.

12. §401(a)(9) – Required Minimum Distributions

Treas. Reg. 1.401(a)(9)-2, A-2(a) provides that except in the case of a 5%-owner, the "required beginning date" is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70-1/2 or the calendar year in which the employee retires from employment with the employer maintaining the plan. Assume that the employee is age 73, is not a 5%-ower, and "retires" on December 31, 2003, as the term "retires" (and related term "retirement") is commonly used by the employer and under the terms of the employer's qualified§401(k) plan. However, in fact what this means is that December 31, 2003, is the employee's last day at work, and the last day for which he is paid or entitled to payment. January 1, 2004 is the first day he is not employed by his employer. When is the employee's required beginning date?

Proposed Response: For the purpose of Treas. Reg. 1.401(a)(9)-2, A-2(a) "the calendar year in which the employee retires from employment with the employer maintaining the plan" is 2004, not 2003, and therefore his required beginning date is April 1, 2005. Moreover, the employee's first distribution calendar year (Treas. Reg. 1.401(a)(9)-5, A-1(b)) is calendar year 2004.

IRS response: The IRS disagrees with the proposed answer. When an employee retires is a facts and circumstances determination, but generally an individual's last day of work is when the employee retires. Other facts, such as the employee returning to work on a sporadic basis after the official date of retirement, could change the answer. But under the facts presented in this question, the last day of service, December 31, is the date of retirement.

13. §401(a)(9) – Required Minimum Distributions

Treas. Reg. 1.401(a)(9)-5, A-4(b) provides that if the employee's sole designated beneficiary is the employee's surviving spouse, then the distribution period (for distributions during the employee's lifetime) is based on the joint life expectancy of the employee and the spouse if greater than the period under the Uniform Lifetime Table. This provision of the regulations goes on to explain that for the joint life expectancy to apply, the spouse must be the employee's sole designated beneficiary for entire year, but also provides certain exceptions in the case of death and divorce.

Assume Employee A was married to Spouse B prior to 2003 and continues to be married to Spouse B, who is 13 years younger than Employee A, throughout 2003 and 2004 (at least). As of January 1, 2003, Employee A has completed a beneficiary designation form for his Employer's §401(k) Plan naming Spouse B and their two Children, C and D, as co-primary beneficiaries, each to receive a one-third share of Employee A's interest in the §401(k) Plan. On May 30, 2003, Employee A completes a new beneficiary designation form under the §401(k) Plan designating Spouse B as his sole primary beneficiary, C and D being relegated to secondary beneficiary status. The beneficiary designation form remains thereafter unchanged through 2004 (at least). Employee A retires from Employer on June 1, 2003, his 72nd birthday. What tables are used to determine the distribution periods for Employee B under the §401(k) Plan for 2003 and 2004?

Proposed Response: The Uniform Lifetime Table in Treas. Reg. 1.401(a)(9)-9, A-2 must be used for 2003 because Spouse B was not Employee A's sole designated beneficiary for 2003. The fact that Spouse B became the sole designated beneficiary before Employee A retired on June 1, 2003 is immaterial. For 2004 the Joint and Last Survivor Table in Treas. Reg. 1.401(a)(9)-9, A-3 must be used because Spouse B was Employee A's sole designated beneficiary throughout 2004 and that table provides a longer distribution period than the Uniform Lifetime Table.

IRS response: The IRS generally agrees with the proposed answer, but notes that when discussing events that result in a change in beneficiary, the regulations intentionally do not reference divorce. If the participant does not change the beneficiary after divorce, the divorced spouse continues to be the designated beneficiary. But if the participant does change the beneficiary, the divorced spouse is still treated as the beneficiary for the entire year for purposes of determining the applicable distribution period. This analysis is relevant for the following responses below as well. [JCEB note: IRS officials did not cite specific regulations in their response, but it is believed the appropriate references are Treas. Reg. 1.401(a)(9)-4, Q&A 4(b) & (c) and Treas. Reg. 1.401(a)(9)-5, Q&A 4(b)(2).]

14. §401(a)(9) – Required Minimum Distributions

Employee A was unmarried in 2003 until he married Spouse B on May 15, 2003. Moreover, Employee A continued to be married to Spouse B, who is 13 years younger than Employee A, throughout the remainder of 2003. Spouse B was Employee A's sole designated beneficiary throughout 2003 under his Employer's §401(k) Plan, including the entire time before the May 15 marriage. Employee A retires from Employer on June 1, 2003, his 72nd birthday. What table is used to determine the distribution period for Employee A under the §401(k) Plan for 2003?

Proposed response: The Uniform Lifetime Table in Treas. Reg. 1.401(a)(9)-9, A-2 must be used for 2003 because although Spouse B was Employee A's sole designated beneficiary for all of 2003, she was not his spouse for all of 2003.

IRS response: The IRS agrees with the proposed answer.

15. §401(a)(9) – Required Minimum Distributions

Employee A was married to wife, Spouse B, on January 1, 2003 and at all times thereafter during 2003 until their divorce on September 15, 2003. Moreover, Spouse B was Employee A's sole designated beneficiary under his Employer's §401(k) Plan at all times during 2003 until September 17, 2003, when he designated Ms. C as his new sole beneficiary. Employee A then married Ms. C, who thereby became Spouse C, on October 12, 2003. Employee A continued to be married to Spouse C throughout the remainder of 2003, and all of 2004, and Spouse C continued to be his sole primary beneficiary throughout that period. Coincidently, A, B and C all share the same birthday, but B is 12 years younger than A, and C is 16 years younger than A. Employee A retires from Employer on June 1, 2003, his 72nd birthday. What table(s) is (are) used, and how are they used, to determine the distribution periods for Employee A under the §401(k) Plan for 2003 and 2004?

Proposed response: The Joint and Last Survivor Table in Treas. Reg. 1.401(a)(9)-9, A-3 must be used for both 2003 and 2004 because for each year Employee A's spouse was his sole designated beneficiary for the entire year. For 2003, Employee A's divorce and subsequent change of designated beneficiary are immaterial. For 2003 the distribution period is based on the lives of A and B, and is therefore 27.0. For 2004 the distribution period is based on the lives of A and C, and is therefore 29.1.

IRS response: The IRS disagrees with the proposed answer, the Uniform Table must be used for that year. There is no tacking rule for spouses.

16. §401(a)(9) – Required Minimum Distributions

Plan A uses the proposed rules published in 1987 under §401(a)(9) ("1987 proposed rules") to satisfy the required minimum distribution requirements for qualified plans. On June 1, 2002, Plan A adopts the proposed rules published in 2001 under §401(a)(9) ("2001 proposed rules"), effective for calendar year 2002 and the final rules published in 2002 under §401(a)(9) ("2002 final rules"), effective as of January 1, 2003 and thereafter. Plan A makes minimum required distributions between 1/1/02 and 4/1/02 for participants who attained age 70 1/2 in calendar year 2001 and between 1/1/03 and 4/1/03 for participants who attained age 70 1/2 in calendar year 2002. Should the Plan use the 1987 proposed rules or the 2001 proposed rules to calculate the distribution amounts paid between 1/1/02 and 4/1/02 since the distributions are being made for calendar year 2001 but payments are actually made in calendar year 2002? Should the Plan use the 2001 proposed rules or the 2002 final rules to calculate the distribution amounts paid between 1/1/03 and 4/1/03 since the distributions are being made for calendar year 2002 but payments are actually made in calendar year 2003?

Proposed response: On, April 16, 2002, the IRS issued the 2002 final rules for minimum required distributions under §401(a)(9). The 2002 final rules state in the preamble: "The regulations apply for determining required minimum distributions for calendar years beginning on or after January 1, 2003. For determining required minimum distributions for calendar year 2002, taxpayers may rely on these final regulations, the 2001 proposed regulations, or the 1987 proposed regulations." Based on this statement, the available rules (i.e., 1987, 2001, and/or 2002 rules) are based on the calendar year for which the minimum required distribution is being made; and there is no reference to an exception for a payment made in a later year than the year to which the payment applies.

Therefore, it would appear that regardless of the year of payment, the rule used to determine a minimum required distribution should be the rule in effect under the plan for the calendar year for which the payment is being made. This result shouldn't change where a plan has adopted a new rule to be effective for a calendar year after the beginning of such calendar year (e.g., switching from the 1987 proposed rules to either the 2001 proposed rules or 2002 final rules or from the 2001 proposed rules to the 2002 final rules). In this situation, the rule used to determine a minimum required distribution for a plan for a prior calendar year will be the rule in effect at the end of such calendar year.

When making a payment in a later year than the year to which the payment applies, Plan A should use the applicable rule that was in effect for the plan for the calendar year for which the minimum required distribution is being made. Therefore, the minimum required distributions Plan A makes between 1/1/02 and 4/1/02 for participants who attained age 70 1/2 in calendar year 2001 should use the 1987 proposed rules to calculate these distribution amounts since the distributions are being made for calendar year 2001 and the 1987 proposed rules were in effect for the plan for calendar year 2001; and the minimum required distributions Plan A makes between 1/1/03 and 4/1/03 for participants who attained age 70 1/2 in calendar year 2002 should use the 2001 proposed rules to calculate these distribution amounts since the distributions are being made for calendar year 2002 and the 2001 proposed rules were in effect for the plan for calendar year 2002.

IRS response: The IRS agrees with the proposed answer. Essentially, the IRS indicates a plan should use the appropriate rules *for* the year the distribution is being made, not the year in which distribution occurs.

17. §401(b) – Remedial Amendment Period - "Deemed Section 125 Compensation"

May the model amendment provided in Rev. Rul. 2002-27 be adopted retroactively (within the remedial amendment period) to include "deemed section 125 compensation" as compensation for all plan provisions that otherwise refer to §125 amounts, (including for purposes of calculating deferrals or contributions), or is the relief provided by the model amendment and the Revenue Ruling limited to §415 purposes and §414(s)(2) purposes?

Rev. Rul. 2002-27 provides that employers may treat participants as being in a cafeteria plan for purposes of §415 even though the plan mandates salary reduction and coverage for participants who cannot prove that they have other insurance coverage. In such cases, the ruling provides that the participants may be treated as having earned "deemed compensation." In addition, the ruling provides a model amendment pursuant to which a plan may count "deemed section 125 compensation" as compensation for various plan purposes. For plan years beginning after December 31, 1997, based on Rev. Proc. 2002-73, the Service will not treat a qualified plan as having failed to satisfy §401(a) as long as the model amendment is adopted within the GUST remedial amendment period. (Note that for many individually-designed plans, the GUST remedial amendment period is open due to pending IRS determination letter requests and for all prototype plans, the period is open until at least September 30, 2003.) Rev. Rul. 2002-27 by its terms specifically provides relief for purposes of sections 415 and 414(s). It does not refer to relief with respect to any other plan definitions of compensation used for deferral and contribution purposes that otherwise incorporate by reference §125 deferral amounts. However, the model amendment included with the ruling indicates that it could be applied to all plan provisions that refer to amounts under §125.

Plans that have treated "deemed section 125 compensation" as compensation in prior years in all likelihood did so for all purposes of plan administration where the plan refers to inclusion of §125 compensation, not just §415 and §414(s)(2). That is, the plan sponsors involved considered the compensation as valid §125 compensation and, as such, added back such amounts to compensation for purposes of actually calculating the amount of plan deferrals and contributions. If a plan cannot utilize the model amendment for bringing its plan definition of compensation into compliance for all purposes, the plan may be in the position not only of having to re-calculate retroactively all nondiscrimination and §415 tests but also of having to correct or reallocate contributions and deferrals for prior years. This is not a logical result as the intent of Rev. Rul. 2002-27 would appear to be to provide relief from disqualification for plans that treated deemed section 125 compensation as actual §125 compensation.

Proposed response: The model amendment provided in Rev. Rul. 2002-27 may be adopted retroactively (within the remedial amendment period) to include "deemed section 125 compensation" as compensation for all plan provisions that otherwise refer to §125 amounts, including for purposes of calculating deferrals or contributions, §415 purposes and §414(s)(2) purposes.

IRS response: The IRS agrees with the proposed answer. The model amendment is intended to be remedial in nature. The IRS noted the blank in the model amendment for indicating the various plan definitions of compensation for which the model amendment can be used is not limited to §415 or §414(s), but can be extended to any plan definition of compensation used for any purpose.

18. §401(b) – Remedial Amendment Period

Will the EGTRRA remedial amendment period apply to (i) all plan amendments adopted on or the first day of the 2002 plan year that would cause an existing plan to fail to be qualified or (ii) only to mandatory and optional amendments adopted pursuant to EGTRRA?

Proposed response: The EGTRRA remedial amendment period should apply to all amendments adopted after the EGTRRA effective date that affect the qualified status of a plan, which is consistent with the approach taken during the GUST remedial amendment period. (See Rev. Proc. 99-23.)

IRS response: The IRS disagrees with the proposed answer. Notice 2001-42 has a different standard than Rev. Rul. 99-23 and only covers mandatory amendments.

19. Section 401(b) -- Remedial Amendment Period

Plan A, the plan year of which is the calendar year, timely filed a GUST determination letter application on February 28, 2002. A favorable determination letter for Plan A was issued by the IRS on March 10, 2003. The letter was conditioned upon the timely adoption of certain proposed amendments by the close of the "remedial amendment period." As of March 10, 2003, Plan A has not yet been updated for any EGTRRA changes that became effective 2002.

1. By when must Plan A's sponsor adopt the proposed amendments upon which the determination letter is conditioned to retain reliance on the letter?

2. What is the deadline for timely adopting the required amendments under Plan A for any EGTRRA changes that became effective in the 2002 plan year?

Proposed response:

1. Under Treas. Reg. 1.401(b)-1(e)(3)(i), the remedial amendment period for a plan for which a determination letter application has been filed ends 91 days after the date the determination letter was issued by the Internal Revenue Service. Thus, Plan A's sponsor

has up to 91 days after the date Plan A's letter was issued, or until June 9, 2003, to adopt the required amendments.

2. Under Notice 2001-42, any required "good faith" EGTRRA amendments must be adopted by no later than (a) the last day of the plan year in which the EGTRRA provision becomes effective under the plan or (b) the end of the plan's GUST remedial amendment period. Thus, Plan A's sponsor has until June 9, 2003 -- the date on which the plan's GUST remedial amendment period ends, to adopt any EGTRRA amendments for the 2002 plan year.

IRS response: The IRS agrees with both proposed answers. The remedial amendment period is tolled by filing for a determination letter, and the plan has 90 days after the issuance of the determination letter to adopt the GUST amendment. The IRS noted an article on this topic will appear in the next edition of the Employee Plans Newsletter.

20. §401(k) – Cash or Deferred Arrangement - Safe Harbor Plan

Company A adopts a safe harbor §401(k) Plan. IRS insists that each year that the safe harbor election is used, the employer must amend the plan to provide that the safe harbor contribution will be employed for that year. Is this correct?

Proposed response: If the Plan contains a default provision, annual amendment to employ the safe harbor is not necessary. The acceptable default provision provides that in any year where the required advance notice that the safe harbor **fails to be given**, the Plan is subject to the standard ADP test. The employer can file a copy of the safe harbor notice with Form 5500. This procedure cuts down unnecessary paper work and is consistent with the statute proving for the safe harbor.

IRS response: The IRS disagrees with the proposed answer. Notice 98-52 requires a notice to participants before the beginning of the year indicating that the plan may be amended during the year to provide for a safe harbor nonelective contribution, and Notice 2000-3 provides for some flexibility by providing a supplemental notice to participants and amending the plan to provide for the nonelective contribution by December 1 of the plan year. There is no default option under existing IRS guidance.

21. §401(k) – Cash or Deferred Arrangements – Participation of Disabled Employee

Can an individual who is completely disabled, but receiving full pay from the employer continue to make §401(k) contributions?

Proposed response: As long as the completely disabled person receives Form W-2 income from the employer, he or she can continue to make §401(k) contributions.

IRS response: The IRS disagrees with the proposed answer. In order to make §401(k) contributions, the individual must be an employee of the sponsor, with the §410(b) definition of employee, which generally requires the individual to be performing services for the sponsor, governing as the definition of employee.

22. §401(k) – Contingent Benefit Rule & Matching Contributions

An employer maintains a money purchase pension plan that provides an annual contribution equal to 10% of compensation. To participate, an employee must elect to defer at least 3% of compensation under a qualified CODA maintained by the employer for the same year. Is the money purchase contribution a "match" because it is "on account of" the participant's elective contribution under the CODA, or is it a nonelective contribution under a defined contribution plan that violates the §401(k) anticonditioning rule?

Consider the same situation, except that the participant will continue to receive the money purchase contribution for all future years even if no further contributions are made after the first year. Are any or all of these amounts matching contributions? How would one test whether or not the match is a nondiscriminatory rate? (Cumulative match divided by the first year deferral?)

Consider a nonelective contribution provided as a discretionary amount allocated to NHCEs who participate in a plan for a particular year. Participants who are employed at the end of the year and who contributed to the plan during the year are entitled to share on a level dollar basis. Is this a match? Or is this a QNEC subject to full vesting and withdrawal restriction if the employer seeks to include these allocations in the ACP test?

Proposed response: Treas. Reg. 1.401(m)-1(f)(12) defines matching contributions as employer contributions to a defined contribution plan on behalf of an employee on account of after-tax contributions or elective deferrals. The regulations state that whether a contribution is "on account of" a contribution or deferral is determined on the basis of all relevant facts and circumstances.

In all three situations, the facts and circumstances lead to the conclusion that the nonelective employer contribution is not a matching contribution because it does not vary based on the amount the employee contributes and because the arrangement can be used as a subterfuge to avoid the requirements for QNECs.

Because the contribution is not a matching contribution, it is not permitted to be contingent on elective deferrals in accordance with §401(k)(4)(A). Treas. Reg. 1.401(k)-1(e)(6)(ii) specifically mentions nonelective contributions to a defined contribution plan as a type of other benefit that may not be conditioned on elective contributions. If such contributions would always be matching contributions, there would have been no need to include this type of contribution in the list of other benefits.

IRS response: The IRS notes that whether a contribution is a matching contribution is a facts and circumstances determination. The IRS agrees that the first and second situations do not describe matching contributions. The third situation is a closer call than the other two, and could be considered a matching contribution with a very low cap, but no specific response was given.

23. §401(k) – Cash or Deferred Arrangement

If a plan provides that the ADP & ACP test will be done with HCE defined as the top 20% and will also be done based on the regular definition of HCE and the employer/administrator will use the results having the least amount of refunds, will it be approved by the IRS?

Proposed response: Yes, it is clearly a definitely determinable allocation formula.

IRS response: The IRS disagrees with the proposed answer. Notice 97-45 requires the plan document to specify whether a top paid group election is made or not.

24. §401(k) – Safe Harbor Cash or Deferred Arrangement

Must a §401(k) plan that is designed as a safe harbor plan require that if a hardship withdrawal is taken, the participant must be suspended from making contributions for six months?

Proposed response: No. Notice 2001-57 was not intended to require that safe harbor §401(k) plans use the hardship withdrawal safe harbor provisions. However, if the plan uses the safe harbor hardship withdrawal provisions, it must shorten the suspension period from 12 months to six.

IRS response: The IRS agrees with the proposed answer. If the plan is using the deemed hardship standards, it must reduce the 12 month suspension to a 6 month suspension period, but a safe harbor §401(k) plan does not have to use the safe harbor hardship standards or suspend contributions for 6 months.

25. § 402 – Taxation of Distributions

When a participant receives a distribution from an account in a plan in which the participant has a basis, e.g., because the participant made employee after-tax contributions to the account, Notice 87-13, Q&A-18, 1987-1 C.B. 432, requires the participant to allocate the basis entirely to the portion of the account that is not rolled over. The effect of this rule is to ensure that none of the employee after-tax contributions are rolled over, and to exempt the portion of the account that is not rolled over from tax to the extent that it does not exceed the participant's basis. Does this rule still apply after EGTRRA (which permitted employee after-tax contributions to be rolled over), and may a spouse (who receives a distribution due to the death of the participant or pursuant to a QDRO) use the rule?

Proposed response: Yes. The flush language of § 402(c)(2), which was added by the Job Creation and Worker Assistance Act of 2002, codifies the rule in Q&A-18. Section 402(c)(9) and (e)(1)(B) extend this treatment to surviving spouses and spouses who are alternate payees under a QDRO.

IRS response: The IRS agrees with the proposed answer.

26. §402(c) - Rollovers

Qualified plans are now allowed to accept rollovers from traditional IRAs. What responsibility does the plan administrator have for keeping track of the employee's basis in the rolled over IRA? Upon subsequent distribution, what would the plan administrator show as the taxable amount on Form 1099-R?

Proposed response: The plan administrator has no way of knowing if the participant has taken a deduction for his IRA contributions, and, therefore, has no responsibility for tracking the participant's basis. As with any traditional IRA, this is the responsibility of the IRA owner. In this regard, upon subsequent distribution, the plan administrator may rely on the participant's initial representation (upon receipt of the IRA rollover) with respect to the IRA basis when filing Form 1099-R.

IRS response: The IRS notes that after-tax money cannot be rolled over from an IRA to a qualified plan, but otherwise agrees with the proposed answer.

27. § 403(b) – Tax-sheltered Annuities

Can a §403(b)(1) annuity or (b)(7) custodial account permit the owner to direct that contributions be invested in individual stocks rather than shares of mutual funds?

Proposed response: No. Section 403(b)(7)(A) requires custodial accounts to be invested in registered investment company shares, and Rev. Proc. 99-44, 1999-48 I.R.B. 598, permits the owner of a §403(b)(1) annuity to direct that premiums be invested in publicly available securities only if no additional income tax liability would have been incurred if the employer had instead paid the amounts into a custodial account that satisfied the requirements of §403(b)(7)(A).

IRS response: The IRS agrees with the proposed answer.

28. §411(a) – Vesting Service Crediting Method

A profit-sharing plan covers only the salaried employees of a plan sponsor. A year of vesting service under the plan is credited for each plan year in which an employee is credited with at least 1,000 hours of service. Since all participants are salaried employees, actual hours of service are not tracked by the plan sponsor. Rather, the plan sponsor credits 40 hours of service for each week a salaried employee is employed. Is this a permissible method of crediting service?

Proposed response: No. If actual hours are not measured, one must credit hours based on an equivalency permitted under the regulations. However, under Labor Reg. §2530.200b-3, 40 hours per week is not a permitted equivalency. Rather, under subsection (e) of the regulations, the plan sponsor would be required to credit 45 hours of service for each week for which an employee would be required to be credited with at least one hour of service.

IRS response: The IRS agrees with the proposed answer. A sponsor cannot do "do-it-yourself" equivalencies. The DOL equivalency rules are the only permitted exception to counting hours for plans.

29. §411(a) – Vesting Requirements

An employee is partially or 100% vested when he/she terminated employment with his/her employer. The employee subsequently returns to employment with the same employer 10 years from his/her original date of termination. Is there any exception to the rule that once an employee is partially or 100% vested, the employer must retain the employee's vested status (i.e., partial percentage or 100%) regardless of the number of years that pass before the employee resumes employment with the employer?

Proposed response: No exception applies. Once an employee is partially or 100% vested, he/she retains his/her partial or 100% vested status upon his/her return to employment with the employer, regardless of the number of years that elapse between the employee's date of termination and rehire.

IRS response: The IRS agrees with the proposed answer.

30. §414(p) – Qualified Domestic Relations Order

Can a payment be made to an alternate payee who is also an employee of the same company and a participant in the same plan, even though the plan precludes in-service distributions?

Proposed response: Yes. The status of the alternate payee is irrelevant.

IRS response: The IRS agrees with the proposed answer. The individual is "wearing two hats" in this situation, and a distribution to the person in their role as alternate payee does not violate the prohibition on in-service distributions to employees. It is the same as if the person were a beneficiary and a participant; the individual could receive a distribution as a beneficiary even if they could not receive a distribution as a participant.

31. §414(v) – Catch-up Contributions

Assume during the 2002 plan year, a HCE makes an $11,000 §401(k) contribution, and therefore could get $29,000 employer nonelective contribution. The §401(k) plan fails the ADP test and the HCE has $1,000 recharacterized as a catch-up contribution, so no corrective distribution is necessary.

Before catch-up contributions were permitted, the $1,000 would have been distributed to the HCE as a corrective distribution and still would have been counted in the §415 limit. But now that the $1,000 is recharacterized as a catch-up, can the employer nonelective contribution be increased to $30,000?

Proposed Answer: According to §414(v)(3)(A)(i), catch-up contributions are not subject to the §415 limits. Assuming the employer nonelective contribution is made within the appropriate time limits for contributions for the 2002 plan year, and subject to the normal nondiscrimination standards for nonelective contributions, the employer can make an additional $1,000 nonelective contribution for the specified employee.

IRS response: The IRS agrees with the proposed answer.

32. §414(v) – Catch up Contributions

Pursuant to Proposed Treas. Reg. §1.414(v)-1(b)(1)(ii), in order to be taken into account for catch-up contribution purposes, a plan-imposed limit must be contained "in the terms of the plan." Will a plan sponsor satisfy this requirement if the plan-imposed limit is stated in the plan's Summary Plan Description (SPD)? Many plan sponsors often set forth plan limits and matching contribution formulas that are subject to frequent change in the SPD rather than the plan document to avoid frequent amendments to the plan document.

Proposed response: A plan-imposed limit contained in the plan's SPD satisfies the requirements under Proposed Treas. Reg. §1.414(v)-1(b)(1)(ii).

IRS response: There are long-standing rules that a plan must be operated in accordance with its terms. If the sponsor believes it has terms in the plan that authorize the plan to limit deferrals of highly compensated employees, then the plan has a plan-imposed limit for catch-up contribution purposes. The plan terms govern the participants' rights to defer and the determination of what is considered a plan-imposed limit. The IRS does not consider there to be a new body of law in addition to the qualification requirement that a plan follow the terms of the plan document, the prohibition on employer discretion, and the definitely determinable benefit rule, to be used in determining whether a plan imposes a limit.

33. §414(v) – Catch up Contributions

Employer maintains a qualified cash or deferred arrangement on a calendar year basis and, for any pay period matches $1.00 for every $1.00 of elective deferrals up to 6% of the employee's compensation made in that pay period. The plan permits catch-up contributions by eligible employees concurrently with elective deferrals throughout the plan year. However, there is no match on the catch-up contributions. In order to avoid a matching issue regarding the catch-up contributions that are re-characterized at the end of the plan year as contemplated by the proposed regulations under §414(v), eligible employees are prevented from making a catch-up contribution in any pay period in which they do not have an elective deferral of at least 6%. Accordingly, there would be no match for re-characterized amounts since the respective contribution would relate to a pay period in which the maximum match was already provided.

1. Is the universal availability requirement violated by restricting catch-up contributions in this manner since a limit (statutory or plan limit) may be reached by certain eligible employees making elective deferrals of less than 6% of their compensation?
2. Is there a violation under §401(k)(4)(A) by restricting catch-up contributions in this manner?

Proposed response:

1. Restricting catch-up contributions in this manner will not violate the universal availability requirement because eligible employees are still provided with an effective opportunity to make the same dollar amount of catch-up contributions. Alternatively, the timing constraints imposed by restricting catch-up contributions in this manner will predominantly (if not entirely) impact highly paid employees. The universal availability requirement is focused on the protection of the non-highly paid employees. Accordingly, restricting catch-up contributions in this manner will not violate the universal availability requirement if it can be shown that all non-highly paid employees were provided with an effective opportunity to make the same dollar amount of catch-up contributions.
2. Restricting catch-up contributions in this manner will not violate §401(k)(4)(A). Section 401(k)(4)(A) was not intended to cover catch-up contributions. Because §414(v) was just recently enacted, §401(k)(4)(A) does not contemplate the application of its provisions to catch-up contributions. Catch-up contributions are considered elective deferrals that are not taken into consideration for purposes of certain limits and nondiscrimination tests. Consistent with the manner in which catch-up contributions relate to other restrictions and provisions of the Code, it would be inconsistent to consider catch-up contributions as "another benefit" for purposes of applying §401(k)(4)(A).

IRS response: The IRS believes most plans are written in terms of what amounts are matched, not in terms of what amounts are not matched, with the possible exception of plan provisions indicating matches on excess deferrals or contributions are not matched. If a plan makes matching contributions on a payroll period by payroll period basis, and a match is provided during the year to an amount that is later characterized as a matching contribution, which is not matched under the terms of the plan, the IRS doesn't believe the match can be taken out later, but there's no need to provide the match during the year.

34. §416 – Top Heavy Plans – Safe Harbor §401(k) Plans

Does §416(g)(4)(H) apply to safe harbor §401(k) plans that consist solely of salary deferrals and safe harbor nonelective employer contributions?

Proposed Answer: Yes. It doesn't matter under §416(g)(4)(H) whether the plan is satisfying the §401(k) safe harbors with nonelective employer contributions or matching contributions. As long as the plan consists solely a safe harbor §401(k) and (m) plan, the plan will not be considered a top heavy plan.

IRS response: The IRS agrees with the proposed answer. The exception from top heavy plan status does not apply only to plans using the matching safe harbor provisions.

35. § 416 – Top Heavy Plans – Safe Harbor §401(k) Plans

Section 416(g)(4)(H) provides that a cash or deferred arrangement that is a safe harbor §401(k) plan by electing to make the safe harbor matching contribution to the plan is deemed not to be a top-heavy plan. If the §401(k) plan document allows the employer to make discretionary profit sharing contributions to the plan, is the plan still deemed to be a non-top-heavy safe harbor §401(k) plan to the extent the employer elects <u>not</u> to make any profit sharing contributions?

Proposed Answer: The fact that a safe harbor §401(k) plan that makes safe harbor matching contributions, but allows the employer to elect to make discretionary profit sharing contributions does <u>not</u> by itself make the plan a top-heavy plan. If profit sharing contributions <u>were</u> made to the plan, since the plan does not consist solely of a cash or deferred arrangement and safe harbor matching contributions, it does not fit within the exception of §416(g)(4)(H) of the Code. Such a plan would be deemed to be a top-heavy plan if as of the determination date 60% of the account balances in the plan are for the benefit of key employees.

IRS response: The IRS agrees with the proposed answer.

36. § 417 – Qualified Joint and Survivor Annuity Requirements

Section 411(d)(6) now generally allows a defined contribution plan to be amended to eliminate all annuity options, including QJSAs. Treas. Reg. § 1.401(a)-20, Q&A-4, says that generally once a participant elects a life annuity option the survivor annuity requirements of § 417 will always apply to his/her benefit. In 1995, in response to another JCEB Q&A, the IRS said that merely having an annuity as the default distribution option is equivalent to electing it for purposes of Treas. Reg. § 1.401(a)-20. Does the IRS still take that position? If so, does it mean that amending a defined contribution plan to eliminate a default annuity option will not necessarily violate § 411(d)(6), but probably will violate § 417?

Proposed Answer: The IRS no longer takes the position that merely having an annuity as the default distribution option is equivalent to electing it for purposes of Treas. Reg. § 1.401(a)-20.

IRS response: The IRS agrees with the proposed answer.

37. §4975 – Employee Stock Ownership Plan

Form 5309 indicates that an ESOP can be a profit sharing plan. Is this an error?

Proposed response: Yes. Section 4975(e)(7) indicates that an ESOP must be a stock bonus plan or a combination of a stock bonus plan and a money purchase pension plan.

IRS response: The IRS disagrees with the proposed answer. The form is also used for any remaining TRASOPs, which could have been a profit sharing plan.

38. §4980B – Continuation Coverage

An employee was a participant in the company's group dental plan at termination of employment, but was not a participant in the company's group medical plan. The employee elected to continue his dental coverage under COBRA. During the period of the employee's dental COBRA continuation coverage, the company had open enrollment for employees. Can the former employee who is receiving dental continuation coverage under COBRA (and is a COBRA qualified beneficiary) elect coverage under the group medical plan during the open annual enrollment period?

Proposed response: The COBRA regulations provide in Treas. Reg. 54.4980B-5(iv) Q&A 4(c) that the same open enrollment period rights available to similarly situated active employees must be available to each qualified beneficiary receiving COBRA continuation coverage. Open enrollment period is defined as a period during which an employee covered under a plan can choose to be covered under another group health plan or under another benefit package within the same plan, or to add or eliminate coverage of family members. Therefore, the individual in the question could elect to participate in the group medical plan during the open annual enrollment period.

IRS response: The IRS agrees with the proposed answer. If the plan did not allow active employees who had previously elected only dental coverage to add group medical coverage during the open enrollment period, the plan would not be required to allow COBRA qualified beneficiaries who had elected only dental to add group medical coverage either.

39. §7805(b) – Employee Plans Compliance Resolution System

B is the beneficiary of the account of his deceased wife who was the sole proprietor of her business. B receives a letter from the trustee of the individually designed qualified plan stating that it must be amended for GUST before the first day of the plan year beginning in 2003. However, no executor or administrator has been appointed before that date to make any amendment of the plan. Will B receive the benefits from a disqualified plan because the amendment to meet GUST is not made by the appropriate date but is made afterward? If the plan is not qualified, B cannot make a rollover.

Proposed Response: The plan will not be qualified unless the amendment is made. The executor or administrator should effect an amendment and follows the rules in Rev. Proc. 2002-47. B must attend to urging that the executor or administrator be appointed ASAP. It would seem that Rev. Proc. 2002-42 (or its successor) offers the path to remove the taint of disqualification. When appointed, the executor or administrator should attend to the amendment of the Plan and submit the amendment to IRS with reference to the procedure available under Rev. Proc. 2002-47 (or its successor). Preferably, the correction should be offered to be made under Section 8 or Section 9 of Rev Proc. 2002-47 where it does not appear that compliance fees must be paid. If compliance fees are to be paid, what provision of the Revenue Procedure does IRS recommend in these circumstances?

IRS response: The IRS agrees and disagrees with the proposed answer. Rev. Proc. 2002-47, sections 8 or 9 discuss operational qualification failures and cannot be used for plan document failures. Section 12.03 provides relief for GUST non-amenders.

40. §9801 – HIPAA Requirements

If a group health plan covers both current employees and retirees but dependent coverage for retirees is limited to a retiree's dependents at the time of his or her retirement (i.e., any new dependent is ineligible) while dependent coverage for current employees includes a new dependent, must the plan permit enrollment by a dependent acquired by a retiree after retirement?

Proposed Response: Section 9801(f)(2)(A)(i) and ERISA §701(f)(2)(A)(i) apply a special enrollment period in the event of a new dependent if the group health plan otherwise provides dependent coverage. Where a different class of eligible dependents is provided for covered current employees than is provided for covered retirees, these statutory provisions, and the related interim regulations, only require coverage of a new dependent if that individual qualifies as a "dependent" under the plan terms as they apply to retirees.

IRS response: The IRS disagrees with the proposed answer. Section 9801(f)(2) does not require that a group health plan provide coverage to any conceivable class of dependent. In general, it is a choice of plan design which classes of dependents are and are not eligible under the plan. Section 9801(f)(2) requires that the plan make special enrollment available to certain classes of otherwise eligible new dependents, such as new spouses or new children. A plan may make coverage available to some, but not all, spouses or some, but not all children. But a plan is not allowed to define the class of eligible spouses or children by when the individual became a spouse or child. Such a time-based restriction would otherwise defeat the special enrollment rights required by §9801(f)(2). Thus, if a retiree plan by its terms allows any current spouse or child under a certain age of a retired participant to be eligible, but excludes any new spouse or child after the retirement of the participant, that plan provision violates §9801(f)(2). To comply with §9801(f)(2), such a plan must grant special enrollment rights to any new spouse or new child under a certain age of a retired participant.