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COMMITTEE ON

EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS
INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

May 7, 2004

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 7, 2004. 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 – Taxation of IRA distribution -

An IRA owner engages in a prohibited transaction with the assets in his IRA   The IRA owner reports and pays ordinary income tax on the value of the IRA as of the first day of the taxable year in which the prohibited transaction occurred. Several years later the IRA owner, now 59½, proposes to liquidate the assets and take a distribution from the IRA. How will the distribution be taxed?

Proposed response: The distribution will be taxed at capital gains rates. The value of the IRA which was recognized as ordinary income in the taxable year of the prohibited transaction will constitute the IRA owner's basis.

Code §4975(c)(3) states in part that if an IRA owner ("individual for whose benefit an [IRA] is established") engages in a prohibited transaction with the IRA, the excise taxes under §4975(a) and (b) do not apply if the IRA ceases to be an IRA by reason of §408(e)(2)(A). Code §408(e)(2)(A) states that if an IRA owner engages in a transaction with the IRA which is prohibited by §4975, the IRA ceases to be an IRA as of the first day of that taxable year. Code §§408(e)(2)(B) and 408(d)(1) state that whenever an IRA ceases to be an IRA because of §408(e)(2)(A), the fair market value of the IRA, determined as of the first day of the taxable year, is treated as distributed and is taxed as provided under §72. Since the Code provides that the IRA "ceases to be an [IRA]," then when the assets in the IRA are subsequently distributed, the IRA is treated as a capital asset of the owner. Any gain on the liquidation and distribution from the IRA over the fair market value determined when the IRA ceased its IRA status, would be determined by subtracting that fair market valuation from the liquidation proceeds and taxed as capital gains to the IRA owner. Because the IRA ceased to be an IRA, the age of the IRA owner at liquidation and distribution is irrelevant.

IRS response: The IRS noted the owner would have been taxed on the IRA before the distribution. The prohibited transaction causes the IRA to lose its qualified IRA status, resulting in taxation to the owner. After the IRA loses its qualified IRA status, it is taxed according to its investments.

2. §72 – Taxation of IRA Distribution

Same facts as above, except that the IRA owner did not report or pay ordinary income tax on the value of the IRA for the taxable year in which the prohibited transaction occurred. IRA owner now proposes to file an amended return, to pay all taxes (and any required interest and penalties) and to liquidate the assets and take a distribution from the IRA. How will the distribution be taxed?

Proposed response: The distribution will be taxed at capital gains rates. Upon filing the amended return and paying all taxes, penalties and interest, the value of the IRA in the taxable year of the prohibited transaction will be recognized as ordinary income for that year and will constitute the IRA owner's basis.

The same analysis described in the previous question applies, once the IRA owner has filed the amended tax return and paid the tax (plus any required interest and penalties) for the earlier year in which the prohibited transaction occurred.

IRS response: The IRS agrees with proposed response.

3. §72(p) – Plan Loans to Participants

Assume that a participant directed his account balance to be invested in a life insurance policy and some years later directed the plan to take out the policy loan to pay a premium. Would that be considered a loan subject to §72(p)?

Proposed response: No. No amounts are distributed to the participant.

IRS response: The IRS agrees with the proposed answer. A policy loan is from an insurance company to the trustee, not from the plan to the participant.

4. §72(p) – Plan Loans to Participants

What is the "date of the loan" for purposes of the five-year limit? Is it (a) the date the loan application is signed, (2) the date the note is signed, or (c) the date the check is delivered to the participant.

Proposed response: The date that the check is delivered to the participant.

IRS response: The IRS agrees with the proposed answer. The date of the loan is when the loan is funded, which is the date the check is delivered in this situation.

§72(p) – Plan Loans to Participants

Plan X is a §401(k) plan allowing up to two loans to be outstanding at any time. P has two loans outstanding. P wants to pay off one of his loans and then take a new loan. Following plan procedures, he requests a payoff amount and then sends a check to payoff the loan. P then requests a new loan. After the proceeds of the new loan are paid to him, P's check that paid off one of the previously outstanding loans bounced. What should be done to correct this?

Proposed response: None.

IRS response: The IRS noted this is an operational failure, but it is not clear what the proper correction is, but noted their belief that good plan administration procedure would wait until the payoff check clears before distributing the proceeds of the new loan.

5. §125 – Cafeteria Plans – Dependent Care Reimbursement Account

Would a registration fee to put an infant on a waiting list at a dependent care facility be reimbursable under a dependent care flexible spending account?

Proposed response: Yes, where the registration fee is required to obtain dependent care services at that facility.

IRS response: The IRS agrees with the proposed answer, but noted that reimbursement should occur only after the reimbursement account owner begins receiving dependent care services, since dependent care expenses can be reimbursed to permit the parent to be at work.

6. §125 – Cafeteria Plans – Dependent Care Flexible Spending Account

An employee has a child with severe medical problems. There have been times where the child is absent from the day care for up to four weeks due to illness. The day care center is requiring the family pay for this missed time and calling it a fee to hold the child's space. Is this reimbursable under a Dependent Care Reimbursement Account?

Proposed response: Yes, because it is necessary to obtain day care services at that particular facility.

IRS response: The IRS did not feel comfortable agreeing with the proposed answer because a dependent care FSA can only reimburse for expenses that allow a parent to work, which does not appear to be the situation under these facts.

7. §223 – Health Savings Accounts

Does the IRS intend to issue a model form for a Health Savings Account Trust or Custodial Agreement?

Proposed response: None.

IRS response: The IRS noted guidance on this issue is planned for the near future.

8. § 280G – Golden Parachute & Exception For Payments Approved By Shareholders

Suppose that the corporation making a payment that might qualify as a parachute payment is part of an affiliated group (as defined in §1504, determined without regard to §1504(b)), and that no member of the affiliated group has any shares that are readily tradeable on an established securities market or otherwise. Suppose further that several members of the affiliated group have minority shareholders who are not themselves members of the affiliated group. Which shareholders must be given the right to vote on the payment in order to take advantage of the exception in Treas. Reg. 1.280G-1, Q&A-6(a)(2)?

Proposed response: The only shareholders who must be given the right to vote on the payment are the shareholders of the ultimate parent of the affiliated group. Neither the shareholders (including any outside minority shareholders) of the corporation making the payment nor the shareholders (including any outside minority shareholders) of any other members of the affiliated group, other than those of the ultimate parent, must be given the right to vote. Under Treas. Reg. 1.280G-1, Q&A-46, an affiliated group is treated as one corporation for purposes of most of the provisions of the regulations, including the provisions relating to exempt payments of certain corporations in Treas. Reg. 1.280G-1, Q&A-6 and Q&A-7, except to the extent specifically provided therein. Logically, the only shareholders who qualify as shareholders of the entire affiliated group, and are legally entitled to vote on issues involving the entire affiliated group, are the shareholders of the ultimate parent.

If the IRS does not agree with this answer, then which shareholders must be given the right to vote on the payment, and how should the votes of shareholders of entities in different chains of corporations within the affiliated group and in different tiers within those chains be weighted for purposes of determining whether the payment has been approved by more than 75% of the voting power of all outstanding stock of the corporation?

IRS response: The IRS agrees with the proposed answer.

9. §401(a) – Return of Employee Contributions

Company X maintains a profit sharing plan for its employees, includes sales employees earning commissions. Under the plan, employees may also make after-tax contributions. During 2002, employee A earned $50,000 in commissions on which plan contributions were based. During 2003, X discovers that $10,000 of A's 2002 commissions were not properly earned and X wants to reverse the treatment. Can the plan recoup the erroneously contributed employer and employee contributions?

Proposed response: None.

IRS response: The IRS noted the employer could recover the contributions if there was a mistake of fact, but noted there not enough facts presented to determine whether a mistake of fact existed. So the IRS could not provide a response to the question and noted there is no ruling procedure for determining the presence of a mistake of fact.

10. §401(a)(4) Nondiscrimination Standards for Benefits, Rights and Features

In addition to the basic benefit formula provided to all plan participants, select HCEs covered by a plan are provided enhanced benefits specified in a special schedule within the plan document. A general nondiscrimination test confirms that the benefit amounts under the plan are nondiscriminatory.

The basic benefits under the plan formula are available for payment in annuity form unless the present value does not exceed $10,000, in which case a lump sum option is available. The supplemental benefit in the special schedule is available in lump sum form without limit.

Is the availability of a lump sum distribution of the supplemental benefit a discriminatory benefit, right or feature?

Proposed response: The ability to cash out the supplemental benefit cannot be combined with the $10,000 lump sum feature available to all participants because of the difference in the portion of the benefit that can be cashed out. See Treas. Reg. 1.401(a)(4)-4(e)(1), last sentence. The select HCEs can always cash out a portion of their benefit while the nonhighly compensated employees cannot. Even if the optional forms could be aggregated, the form would fail the effective availability requirement because only the HCEs are guaranteed the right to some portion of the benefit in lump sum form. The plan would need to be changed to allow others the right to a lump sum distribution of a similar portion of their benefit to retain the option for HCEs.

IRS response: The IRS agrees with the proposed answer. The enhanced benefit is a discriminatory benefit, right or feature since the supplemental benefit lump sum cannot satisfy the current availability standard.

11. §401(a)(4) – Nondiscrimination Standards and Determining Accrual Rate for Participants in Frozen Plan

Controlled Group A has multiple pension plans. Plans 1, 2 and 3 are active DB plans with participants who currently accrue benefits. Plan 4 is a frozen DB plan that does not adjust benefits to reflect current service or compensation (hard freeze). Plan 3 fails the §410(b) ratio percentage test. Thus, the DB plans are combined to pass coverage. Accrued to date testing is used for general nondiscrimination testing and for the average benefits percentage test (ABPT).

For the accrued to date method, in the case of participants in plan 4, should the accrual rate be determined by dividing the frozen accrued benefit by service and pay at the freeze date or at the end of the testing year?

Proposed response: If a participant is not currently "benefiting" because there are no current changes in service or compensation taken into account other than for reasons specified in the regulations, then the participant is not taken into account at all for general testing. Only participants who are benefiting are considered.

For the ABPT, all employees are considered without regard to whether they are benefiting. For a participant with a frozen accrued benefit who is not currently benefiting, testing service does not change merely because the participant continues in service. However, average compensation is required to reflect years until termination of employment.

IRS response: The IRS agrees with the proposed answer.

12. §401(a)(4) – Nondiscrimination Standards and Cross Testing

The nondiscrimination regulations under Treas. Reg. 1.401(a)(4)-9(b)(2)(v)(D) describe the minimum aggregate allocation gateway that must be satisfied in order to cross-test a DB/DC plan. Consider the situation where a DB and DC plan are aggregated for testing purposes. The DC plan has an end-of–the year condition for receiving an allocation. All employees who were plan participants during the year are in the testing group and all employees participate in both plans. If a participant leaves in October (calendar year plan) after he has accrued a DB benefit, the plan will fail the gateway test because he did not receive a DC allocation for the year. How should it be handled?

Proposed response: The person must get an allocation that satisfies the minimum aggregate allocation gateway.

IRS response: The IRS agrees with the proposed answer.

13. §401(a)(4) – Nondiscrimination Standards & Definition of Deferrable Pay

What standard (if any) applies to a plan that limits which "pay" an employee can defer from? For example, if elections to defer are limited by the terms of the plan to cash-based compensation on regular paychecks, and the employer regularly does bonuses on a separate payroll check, does the IRS believe that there is a mathematical test required of who has how much pay excluded from the deferral opportunity?

Proposed response: None.

IRS response: The definition of compensation under this plan structure would be considered a separate benefit, right or feature and subject to nondiscrimination testing under the current and effective availability tests.

14. §401(a)(9) – Required Minimum Distributions and Date of Retirement

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.

If December 31, 2003 is the employee's last day at work, and the last day for which he or she is paid or entitled to payment of wages, is that the date of "retirement". Or is January 1, 2004, the first day the employee is not employed, the retirement date? When is the employee's required beginning date?

Proposed response: "Retirement" is the last day worked, not the definition of retirement date in the plan. What date is an employee's last day worked is a facts and circumstances determination. The facts and circumstances are based on the employer's practice concerning the last day an individual is considered an employee.

IRS response: The IRS agrees with the proposed response and noted that they have never defined "retirement." Based on the facts in the described situation, the participant's date of retirement would be December 31, 2003.

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

Many qualified plans, §457 plans and §403(b)s calculate required minimum distributions (RMDs) for participants using the Uniform Table for all calculations. (The primary reason for this is that in the case of a participant whose sole primary beneficiary is the participant's spouse who is more than 10 calendar years younger, the plan could use the Joint and Survivor Table. However, it is very difficult for the plan sponsor to learn in any year if the spouse has died or if the couple has gotten divorced during the year such that the employer must use the Uniform Table. This is especially problematic if either of these events occurs late in the year. Using the Uniform Table in all instances ensures that at least the RMD has been paid for the year for all participants.)

Technically, for those participants who would otherwise qualify to have their plan RMDs calculated using the Joint and Survivor Table, the plan RMD is larger than the minimum required under the Code (i.e., using the Uniform Table). Some argue that the participant should be able to roll over the excess between the RMD calculated using the Uniform Table and the amount calculated using the Joint and Survivor Table (here called "Excess").

Assuming the individual is receiving annual payments of the RMD (as opposed to a cash-out of his entire account balance or payments over a short number of years), must the excess be treated by the plan and/or the participant as eligible for rollover? What withholding rules apply to the excess?

Proposed response: Assuming that the plan is distributing the RMD each year using the methodology described above, both the plan and the participant cannot treat the excess as eligible for roll over, and the "voluntary" withholding rules apply.

If an individual is receiving annual RMD payments (as opposed to a cash-out that consists partly of an RMD - see the following question), those payments qualify as "substantially equal periodic payments made at least annually over life expectancy or joint life expectancy." This is true even if more than the statutory minimum RMD is being paid (i.e, the plan calculates the RMD using the Uniform Table when the individual would otherwise qualify for the Joint and Survivor Table). Therefore, the Excess is not eligible for roll over. (Incidentally, this result makes withholding more straightforward. In treating these payments as not eligible rollover distributions, the plan can apply the same withholding "voluntary" rule to the entire distribution.)

IRS response: The IRS indicated the excess portion of the distribution is not available for rollover, citing Notice 97-75. Distributions determined using the Uniform Table would be considered substantially equal periodic payments, so there is no excess amount that is not considered a required minimum distribution.

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

In situations where the plan forces out a participant's entire account balance (or pays the balance in a method that otherwise would qualify as an eligible rollover distribution) and the plan again uses the Uniform Table in all circumstance to determine the RMD, may the plan treat the excess as not eligible for rollover and apply "voluntary" withholding? Can the participant treat the excess as eligible for roll over? (A plan would not always know whether the excess truly is an excess and eligible for roll over for the reasons described in the previous Q&A.)

Proposed response: Yes to both questions.

In instances where the plan forces out the individuals' entire account balance in the 70 1/2 year (or later) or pays in any other method that would otherwise qualify as an eligible rollover distribution, the plan may treat the Excess as an RMD that is not eligible for rollover. (However, assuming the other requirements are met, the amount in excess of the plan-calculated RMD is eligible for rollover, and the plan will give the individual the opportunity to effect a direct rollover of that excess amount.) The plan would apply the "voluntary" withholding rules to the plan-calculated RMD, and the mandatory 20% withholding rules to any amount above that that is not directly rolled over.

If the plan calculates the RMD portion of the payment using the Uniform Table, but the individual otherwise would have qualified for the Joint and Survivor Table (and the distribution otherwise would qualify for roll over), the individual can rollover him/herself the difference between the Uniform Table amount and the Joint and Survivor Table amount even though the plan treats the Excess as not eligible for rollover (and the plan applies "voluntary" withholding on the amount of the entire plan-calculated RMD).

IRS response: For purposes of §401(a)(31), the plan can treat the participant as not having a designated beneficiary, so the plan could use the Uniform Table for RMD purposes. See Treas. Reg. 1.401(a)(31)-1, Q&A 18. The recipient of the distribution could rollover the difference between the Uniform Table amount and the amount actually distributed.

17. §401(a)(9) – Required Minimum Distributions

Since the adoption of the final regulations is mandatory and providers are operating under those final regulations, what is the consequence to a plan if they do not execute the model amendment or otherwise formally adopt those regulations on a timely basis. It would seem a stiff penalty to require that they follow the VCP process when the adoption of the final regulations was not discretionary, i.e., it is not like they can ignore those regulations.

Proposed response: There should be some latitude that would allow a sponsor to essentially self correct under SCP by adopting the amendment as soon as they become aware that they did not adopt it timely.

IRS response: The IRS disagrees with the proposed answer, and noted that the VCP process should be followed in this situation.

18. §401(k) – Hardship Distributions

An employee requests a hardship withdrawal from his §401(k) plan in order to purchase a home which he claims will be his primary residence. The new home is in a completely different geographic area of the country (chosen due to the health concerns of his family members) and not within a reasonable commuting distance from work. The employee admits that he will not be living there for at least a year. However, his wife and children will be living there during that time. Assuming the immediate need and all other requirements for purposes of a hardship distribution are satisfied, is this withdrawal for the "purchase of an employee's primary residence?"

Proposed response: Yes, it is sufficient that the home is the primary residence of the employee's family.

IRS response: The IRS disagrees with the proposed answer, noting that the home must be the principal residence of the employee, not just the employee's family.

19. §401(k) – Hardship Distributions

A participant wants to know if the purchase of principal residence qualifies as a hardship if she is using the proceeds to 'buy out' the equity on her current home from her ex-spouse?

Proposed response: Yes, because the dwelling is her principal residence and she is purchasing an interest in it that she didn't own before.

IRS response: The IRS agrees with the proposed answer. The participant is purchasing a part of her principal residence.

20. §401(k) – Hardship Distributions

Can a participant receive a hardship distribution on account of college expenses that were incurred in the past year?

Proposed response: The regulations are quite explicit that college expenses can be covered by a hardship distribution only on a prospective basis.

IRS response: The IRS agrees with the proposed answer.

21. §403(b) – Tax-sheltered Annuities & Timing of Contributions

School District X maintains a §403(b) plan to which salary reduction and employer contributions are made. Because school districts and §501(c)(3) tax-exempt organizations are not subject to income taxes (and therefore the tax deduction rules of §404 do not apply), what is the due date for remitting employer contributions?

Proposed response: Treas. Reg. 1.415-6(b)(7) provides that annual additions are credited for a limitation year if they are made, for income-tax exempt employers, no later than 5 1/2 months after the close of the taxable year with or within which the limitation year ends.

IRS response: The IRS agrees with the proposed answer, although they noted the regulation cited actually provides that annual additions are credited for a limitation year if they are made, for tax-exempt employers, no later than the 15th day of the sixth month following close of the taxable year (or fiscal year if no taxable year) with or within which the limitation year ends.

22. §404(a) – Deductible Limit

Can the aggregate deduction for contributions made by a corporation to its qualified plans, including an ESOP, exceed 25 percent of covered compensation in situations where the portion of the aggregate contribution made to the ESOP is: (a) applied by the ESOP to the repayment of the principal of a stock acquisition loan, and (b) not in excess of 25 percent of covered compensation? For instance, can a corporation contribute 25 percent of covered compensation to its profit sharing plan and an additional 25 percent to its ESOP which, in turn, uses that contribution to make principal payments on a stock acquisition loan?

Proposed response: Section 404(a)(9)(A) starts with the language, "[n]otwithstanding the provisions of paragraphs (3) [dealing with contributions to stock bonus and profit sharing plans] and (7) [dealing with the 25 percent combined limit on contributions to both defined benefit and defined contribution plans]. . . ." Accordingly, pursuant to this language, it could be argued that so long as the contributions under §404(a)(9) do not exceed 25 percent of covered compensation and are used by the ESOP to pay principal of a stock acquisition loan, they should be deductible, notwithstanding that contributions up to 25 percent of aggregate employee compensation have been made to other plans maintained by the same employer (provided that the limits under §415 are not exceeded).

IRS response: The IRS agrees with the proposed answer. The special ESOP deduction rule applies after the normal deduction rule. The other contributions can be "stacked" first and then the special rule for ESOP contributions can be applied. See PLR 9548036.

23. §404(k) – Deduction for Dividends on Employer Securities

How does one determine whether an "applicable dividend" paid by a closely-held corporation should be disallowed as constituting "an evasion of taxation?" Under what circumstances would such a dividend that otherwise qualifies under §404(k) be deemed to be other than "reasonable?"

Proposed response: According to the legislative history of TRA '86 (S. Rept. page 1034, TRA-86 Conf. Rept. II 852; and Technical Corrections Blue Book, page 158) the reasonableness of a dividend should be based on whether such a dividend, together with any other compensation paid to the recipient, would violate the "reasonable compensation test." Such a test would be extremely difficult to apply since dividends are paid pro rata based upon stockholdings, while reasonable compensation is determined on an individual recipient basis. The IRS has ruled in PLR 9304003 that "reasonable" dividends should be determined by what a corporation can be expected to pay on a recurring basis. There is, however, an extensive body of law which focuses on the corollary of this question as it applies to the accumulated earnings tax. Under §531, this tax applies to corporations that fail to distribute earnings not needed in the business as dividends to their stockholders. Would it not be appropriate to apply the rules that are used to determine whether the retention of earned income is justified to determine the analogous question whether a dividend paid by an ESOP company is "reasonable" under §404(k)?

IRS response: The IRS agrees with the proposed answer.

24. §404(k) – Deduction for Dividends on Employer Securities

A closely-held company has a convertible preferred stock that pays a seven percent dividend. This dividend is used to make payments on the ESOP's stock acquisition indebtedness, and is not used for the dividend reinvestment under §404(k)(2)(A)(iii). The company has sufficient cash flow to pay this dividend on a recurring basis. No similar publicly traded company pays common dividends in excess of four percent. How is the reasonableness of this dividend determined for purposes of the "avoidance or evasion" disallowance authority under §404(k)? Does the Conference Committee publicly traded common stock standard apply only to the deductions for dividend reinvestments under new §404(k)(2)(A)(iii)? Does the "payable on a recurring basis" standard continue to apply for dividends used to make loan payments or that are passed through in cash to participants without a reinvestment option?

Proposed response: The conference committee report provisions on reasonableness of dividends appear to apply only to dividends deducted under § 404(k)(2)(A)(iii), and not to dividends deducted under other parts of §404(k).

IRS response: The IRS agrees with the proposed answer. EGTRRA's legislative history applies to elective and regular dividends, so that it becomes a facts and circumstances issue whether it is reasonable, including the sustainability of the dividend, comparable to dividends by other employers.

25. §408 – Rollovers

Rev. Rul. 2004-12 concludes that eligible retirement plans that separately account for amounts attributable to rollover contributions may distribute those amounts at any time pursuant to the participant's request (with spousal consent, if applicable). The ruling does not qualify this conclusion by the type of rollover (pre-tax or after-tax dollars) or by type of plan (e.g., pension or profit-sharing). Therefore, it appears that the ruling would apply to pre-tax money rolled over to and separately accounted for by a money purchase pension plan. This is somewhat surprising since the same logic that dictates such rollover account would normally be subject to the spousal consent requirements would also dictate that no distribution could be made from the account until the participant terminated employment or attained normal retirement date. Rev. Rul. 2004-12 cites in support of its conclusion Rev. Rul. 69-277 (pension plan may distribute "employee's after-tax contributions prior to the employee's termination of employment") and Rev. Rul. 94-76 (allowing a profit-sharing plan to distribute immediately amounts attributable to a rollover). Of course, neither of these rulings, as described, addresses the withdrawal of pre-tax employee contributions from a pension plan. How did the IRS reach the conclusion that it appears to reach (as explained above) regarding the withdrawal of rollover accounts at any time from a pension plan?

Proposed response: Too much is made of the term "after-tax contributions" in Rev. Rul. 2004-12's discussion of Rev. Rul. 69-277. Actually, the holding of Rev. Rul. 69-277 was that earnings attributable to voluntary contributions may be withdrawn along with the voluntary contributions. Rev. Rul. 69-277 never uses the term "after-tax contributions." Of course, in 1969 voluntary contributions, as the term was used then (and in certain contexts still is today), would have been "after-tax" contributions. Rev. Rul. 60-323, cited in Rev. Rul. 69-277, provides that voluntary employee contributions may be withdrawn from a pension plan. The emphasis there is that the withdrawal does not affect the basic benefits provided by employer and compulsory employee contributions (if any), and not on the fact that the voluntary contributions are "after-tax." Rollover contributions, whether pre-tax or after-tax, are analogous to voluntary employee contributions of the kind that were the subject of Rev. Rul. 60-323, in that they provide supplemental benefits of the employee's choosing (that is, by the employee's choice to put money in the plan to provide additional retirement benefits), and their early withdrawal would not affect the basic pension benefits provided under the plan by employer contributions.

IRS response: The IRS reaffirmed the rationale in Rev. Rul. 2004-12. The rationale of the ruling is that there are certain rules for benefits attributable to contributions under certain types of plan, but those requirements would be eliminated by rolling the benefit over to another plan, though other restrictions may continue to apply such as the QJSA rules and required minimum distribution rules.

26. §409(l) – Definition of Employer Securities

Approximately ten percent of an ESOP company's workforce consists of leased employees, who are on the payroll of a leasing organization, but who work on a full-time basis for the ESOP company under its direction and control. May these employees be included as participants in the ESOP, and receive allocations of ESOP company stock? Or would that violate the "employer securities" provisions of §409(l) with respect to these employees?

Proposed response: Although the statutory language can be read to exclude these employees, it is not consistent with the general purpose of Congress in permitting and encouraging ESOPs. The situation would be exacerbated if their exclusion were to cause a §410(b) coverage failure.

IRS response: The IRS disagrees with the proposed answer. The answer assumes the workers are not common-law employees of the sponsor, but are leased employees. The employees must be employed by the controlled group in order to participate in the ESOP. Notice 84-11 does not list 409(l) as treating leased employees as employees of the sponsor for this purpose.

27. §409(n) – Securities Received in §1042 Transaction

A, B, C, and D are brothers and sisters. They each own 25,000 shares of X Corporation, which shares constitute all of the issued and outstanding shares of X. All of the X shares held by A, B, C, and D are "qualified securities" within the meaning of §1042 of the Code. A, B, C, and D each sell 10,000 of their X shares to an ESOP sponsored by X in a single transaction. Only A elects to defer tax under §1042. Can B, C, and D participate in the ESOP if they are employed by X? Can children of B, C, and D who are employed by X participate in the ESOP?

Proposed response: Under the rationale of PLR 9001035, it would appear that the non-electing sellers would be able to participate in the allocation of shares under the ESOP, but the electing shareholders would not be able to participate in the allocation of any shares under the plan.

IRS response: B, C, and D cannot participate because they are related to A under the family attribution rules, but their children can participate in the ESOP. The children of B, C, and D are not related to A under the attribution rules of §267(b).

28. §409(p) – S Corporation ESOPs

Does "synthetic equity" include rights to acquire existing outstanding stock under buy-sell agreements or under wills? Consider the following examples:

a. An ESOP, Henry, and Barbara each own one-third of a company. Henry and Barbara have a shareholder's agreement giving each the right to purchase shares from the other at fair market value upon the other's death. Does this shareholders' agreement create synthetic equity with regard to two-thirds of the company's stock?

b. David owns 60 percent of a company and an ESOP owns 40 percent. David has a will, leaving all of his stock to his wife upon his death. Does his wife have synthetic equity of 60 percent of the company?

Proposed response: There is no abuse where the right is to acquire existing shares rather than newly-issued shares, and the reference in §409(p)(6)(C) to rights "similar" to stock options, warrants, restricted stock, and deferred issuance stock rights should be interpreted as rights to acquire newly-issued shares.

IRS response: Treas. Reg. 1.409(p)-1(f)(2) indicates buy-sell agreements are not considered synthetic equity. It is reasonable to apply the same rule for a will.

29. §409(p) – S Corporation ESOPs

A plan document includes the §409(p) prohibited allocation rules, but a prohibited allocation occurs anyway. Is the plan disqualified?

Proposed response: The conference committee report says no, but that would appear to be contrary to other IRS policy.

IRS response: The IRS thought the conference report indicates synthetic equity did not disqualify the plan, not that a prohibited allocation doesn't disqualify the plan. The IRS is considering the issue and trying to determine whether the plan loses its status as an ESOP, rather than be disqualified.

30. §409(p) – S Corporation ESOPs

For purposes of § 409(p) testing, assume that a company has 100 shares of stock outstanding, all of which are held by the ESOP, that eleven persons have options to acquire ten shares each, and that these eleven individuals have no other stock ownership (outright or "deemed") or "synthetic equity."

i. Are any of the eleven individuals "disqualified persons?"

ii. Is the year a non-allocation year?

Proposed response: Section 409(p)(5) reads in part as follows: "[S]hares of stock in such corporation on which such synthetic equity is based shall be treated as outstanding stock in such corporation and deemed-owned shares of such person if such treatment of synthetic equity of 1 or more such persons results in (A) the treatment of any persons as a disqualified person, or (B) the treatment of any year as a non-allocation year."

Accordingly, synthetic equity owned by a person who owns less than 10 percent of the stock (including synthetic equity) would not be a disqualified person, and if disqualified persons do not own 50 percent or more of the outstanding stock, there will not be a non-allocation year.

IRS response: The fact pattern made the IRS officials "nervous," and it was noted the IRS is currently considering a variety of issues surrounding synthetic equity and S Corp ESOPs. The IRS did not feel able to determine an answer to this question at this time.

31. §409(p) – S Corporation ESOPs

Revenue Ruling 2003-27 implies that undistributed S corporation income should be reported on the Form 5500. However, there appears to be no place on Form 5500 or the related schedules to report this income, and many small plans are not even required to file

Schedule H (Financial Information), which is the only schedule on which this type of information may be reported. Must undistributed S corporation income be reported on Form 5500? If not, is basis adjustment still required?

Proposed response: It appears that reporting such amounts, which are not plan assets and do not flow through the plan, is inappropriate, but basis adjustment is required.

IRS response: The employer is required report on schedule H as other income. Basis adjustment is required. The IRS indicated they were considering changing the instructions to the Form 5500, but the amounts need to be reported.

32. §409(p) – S Corporation ESOPs

According to Revenue Ruling 2003-27, the basis of S corporation stock owned by an ESOP is increased by undistributed S corporation earnings (i.e., the AAA account).

a. Will distribution of an amount equal to that account balance by the S corporation to its shareholders, including its ESOP, reduce stock basis back down to its original cost basis, thus restoring full net unrealized appreciation ("NUA") long-term capital gain entitlement to ESOP participants who receive that stock as part of a lump sum distribution from the ESOP?

b. Would there be a problem if an S corporation desired to restore the full NUA potential of the ESOP participants by distributing its AAA account?

Proposed response: This should be nothing more than an administrative calculation that, under the rationale of Revenue Ruling 2003-27, is used to calculate ordinary income and NUA on the distribution of stock by an S corporation ESOP.

IRS response: The IRS does not have a specific rule on this issue, but was sympathetic to the basis adjustment issue.

33. § 410(b)(6)(C) – Special rule for certain acquisitions and dispositions

Does § 410(b)(6)(C) apply to a merger of one entity into another entity, or the purchase of the assets of one entity by another entity, where neither entity has any affiliates? The provision by its terms applies only when "a person becomes, or ceases to be, a member of a group described in subsection (b), (c), (m) or (o) of section 414".

Proposed response: Yes. Although § 410(b)(6)(C) by its terms does not apply to this situation, the last sentence of Treas. Reg. § 1.410(b)-2(f) – which was added in 1991 in response to an ABA comment that the provision should apply whenever an asset sale is the equivalent of a change in control as defined in Code § 410(b)(6)(C)(i) – extends the provision to any asset or stock acquisition, merger or other similar transaction involving a change in the employer of the employees of a trade or business, regardless of whether either of the employers involved is or was a member of a group of employers under Code § 414(b), (c), (m) or (o).

IRS response: The IRS agrees with the proposed answer. The special rule applies to the broader definition of a change the controlled group, which can include an asset sale.

34. §411 – Involuntary Cash-out Distributions of Post-rehire Accruals

Assume a participant in a defined benefit plan terminates employment prior to normal retirement age and begins to receive an annuity benefit of his/her entire accrued benefit. Several years later, this same individual is rehired and begins to earn additional accruals.

Can the plan involuntarily cash out the value of the participants' additional accruals (i.e., accruals after rehire) upon subsequent termination?

Proposed response: The additional accruals can be involuntarily cashed out if and only if the present value of the entire accrued benefit (including the present value of the remaining portion of the original annuity benefit) is below $5,000 at that time.

Note that the original annuity benefit cannot be involuntarily cashed out since it is after the annuity start date for that benefit.

IRS response: The IRS agrees with the proposed answer. The participant can be cashed out as long as the remaining portion of the benefit is less than $5,000. The remaining portion of the original benefit cannot be cashed out because it has already had an annuity starting date.

35. §411(a) – Forfeiture of Benefits & Rule of Parity

Pursuant to Treas. Reg. 1.401(k)-1(c)(1)(ii), deferrals are disregarded for purposes of applying §411(a) to other contributions. Does this apply to the rule of parity?

Proposed response: Yes. Thus, the fact that a participant is fully vested in his or her §401(k) contributions does not preclude the application of the rule of parity.

IRS response: The IRS disagrees with the proposed answer. Elective deferrals are considered employer contributions for all qualification purposes, so no service can be disregarded under the §411(a)(6)(D) rule of parity.

36. §411(a)(7)(C) – Buy-back of Cash out Distribution

Section 411(a)(7)(C) provides that the accrued benefit of an employee that is disregarded by the plan must be restored upon repayment to the plan by the employee of the full amount of the distribution. Employee A participated in Employer's qualified defined benefit pension plan, terminated employment, received a lump sum distribution of the present value of his normal retirement benefit and rolled over his lump sum distribution from the plan into an IRA. The lump sum distribution did not include the value of any early retirement subsidies. Employee A was rehired by Employer and would like to repay the Employer's defined benefit plan the full amount of the distribution with pre-tax IRA funds. The repayment will be part of the Employer's defined benefit pension plan trust and will not be segregated in a separate account in the name of Employee A. May the Employer's defined benefit pension plan accept pre-tax funds from Employee A's IRA as repayment and include the repayment as part the trust's general assets? Does the answer vary if the amounts in the IRA are not funds from a tax-qualified plan distribution? Is the repayment from Employee A's IRA to the Employer's tax-qualified defined benefit plan a taxable event to Employee A?

Proposed response: Employer's defined benefit pension plan may accept the pre-tax funds from Employee A's IRA as repayment of the prior distribution and include such amounts as part of the trust fund's assets. The repayment provisions of §411(a)(7)(C) and Treas. Reg. 1.411(a)-7(d) do not state that only after-tax funds may be used to repay a pension plan and does not require that the repaid amounts be specifically set aside in a separate account for the participant. The answer is the same whether or not the pre-tax funds in the IRA originated from a tax-qualified plan. The amounts repaid by Employee A from his IRA to Employer's defined benefit pension plan will not result in ordinary income to Employee A because the amount is not distributed to Employee A.

IRS response: The IRS agrees with the proposed response. It doesn't matter whether the buy-back is made with pre- or post-tax funds. The source of the money used for the buy-back is not important, but buying back a benefit with after-tax funds may create basis in the benefit for the participant. The source of the funds might be relevant to whether lump sum distribution treatment is available for the ultimate distribution from the qualified plan.

37. §411(a)(10) – Change in Vesting Schedule

Is the change from elapsed time to hours of service (or vice versa) a change in vesting schedule that permits employees to elect the prior vesting schedule?

Proposed response: It is not a change in vesting schedule. The elapsed time regulation contains its own rule for protecting participants where the plan changes from one methodology to another.

IRS response: The IRS agrees with the proposed answer.

38. §411(a)(10) – Change in Vesting Schedule

If a plan with 3-year cliff vesting (the "Merged Plan") is merged into a plan with 5-year graded vesting at 20% per year (the "New Plan") are the requirements of §411(a) and Treas. Reg. 1.411-8T satisfied with respect to employees with three or more years of service who participated in the Merged Plan, if, without any election by employees, the benefits of such employees (i) accrued under the Merged Plan, are fully vested as of the date of merger and (ii) accrued under the New Plan, are subject to the vesting schedule of the New Plan. (The benefits accrued under the Merged Plan of employees with less than three years of service are subject to the vesting schedule of the New Plan.)

Proposed response: Yes. Treas. Reg. 1.411-8T states that no election need be provided for any participant whose nonforfeitable percentage under the plan, as amended, at any time cannot be less than such percentage determined without regard to such amendment. Since the benefits accrued under the Merged Plan by employees with three or more years of service remain 100% vested under the New Plan, no election is necessary. The requirements of Treasury Regulation Section 1.411-8T apply only to benefits accrued as of the effective date of the amendment and not to benefits subsequently accrued under the New Plan.

IRS response: The IRS disagrees with the proposed answer. The prior vesting schedule applies to the entire accrued benefit, both existing and future accruals.

39. §411(a)(11) – Participant Consent

A terminated participant in a §401(k) plan has a total account balance of $5,500, of which $2,500 is an outstanding loan. If the loan is deemed distributed prior to the date on which his benefit would be payable, is the participant's account balance considered to be $5,500 or $3,000 for purposes for the $5,000 cash-out rule.

Proposed response: The participant's account balance is $5,500 for this purpose because it includes his entire vested account balance.

IRS response: The IRS disagrees with the proposed answer. On the particular date, the participant's benefit is $5,500, but if there was an offset for the loan, the remaining vested benefit could be cashed out. So if the loan offset occurs before the time for the cash out distribution, the participant can be cashed out.

40. §411(d)(3) – Partial Termination

When determining if a partial termination has occurred in a §401(k) plan pursuant to Section 411(d)(3) of the Code, is the relevant measurement (a) the decrease in the number of employees who actually participate in the plan or (b) the decrease in the number of employees eligible to participate in the plan?

Proposed response: The relevant measurement is the decrease in the number of employees who actually participate in the plan, as an employee who was eligible to participate in the plan, but chose not to, will not incur a forfeiture as to a benefit under the plan if his or her employment is terminated. The partial termination worksheet in the instructions to Form 5300 for a determination as to a partial termination refers to "participants" and not to eligible employees. Accordingly, the statement in Treas. Reg. 1.411(d)-2(b)(1) that the exclusion, by reason of a plan amendment or severance by the employer, of a group of employees who have previously been covered by the plan is intended to refer to participants and not to eligible employees.

IRS response: The IRS disagrees with the proposed answer. The relevant measure is participants who are eligible to defer, not just those participants who defer under the plan.

41. §411(d)(6) – Anti-cutback Rule

A money purchase pension plan was maintained pursuant to a regional prototype plan document under which the qualified pre-retirement survivor annuity was based upon 100% of the participant's vested account balance. The plan was timely amended and restated for GUST using a prototype document which provides that the qualified pre-retirement survivor annuity is based upon 50% of the participant's vested account balance. Does the reduction of the QPSA from 100% to 50% constitute a cutback of an accrued benefit?

Proposed response: No, so long as (i) the participant is living at the later of the time the amendment is made or the effective date of the amendment and (ii) a qualified domestic relations order providing otherwise is not in existence at the later of the time the amendment is made or the effective date of the amendment. A 50% QPSA is the maximum amount required under the Code. Although Treas. Reg. §1.411(d)-(4), Q&A 2(a)(4) provides that the anti-cutback rule applies to beneficiaries as well as participants, §411(d)(6) protections do not apply to a beneficiary until the participant's death unless a QDRO provides otherwise. To the extent it would be considered a cutback of an accrued benefit, the 100% QPSA can be maintained under the prototype document with respect to benefits accrued as of the later of the date of amendment or its effective date by attaching an addendum to the prototype document preserving this benefit without such attachment causing the plan to lose prototype status.

IRS response: The response to this issue is likely connected to the same question in the *Heinz* case currently before the U.S. Supreme Court, concerning whether a change in a plan's suspension of benefit provisions is governed by §411(d)(6). The plan could have provided for the described QPSA initially, but it is not clear whether the plan can change the death benefit. The answer will have to wait until the decision in the *Heinz* case.

42. §411(d)(6) – Anti-cutback Rule

Is it a violation of the anti-cutback rule for a plan to adopt the default rollover provisions of §401(a)(31)? For plans that currently provide a mandatory distribution for benefits with a present value less than $5,000, the form of payment made absent an affirmative election by the participant is the distribution of a check for the amount of the participant's benefit. In order to comply with the default rollover requirements of §401(a)(31), that distribution option will be eliminated and replaced with another optional form of benefit where the form of payment made absent an affirmative election by the participant is the transfer of benefits to eligible retirement plan.

Treas. Reg. 1.411(d)-4, Q&A 2(b)(2)(v) indicates that involuntary distributions may be reduced or eliminated without violating the anti-cutback rule. However, Q&A 24 from the 2001 IRS Q&A session with the JCEB indicates that the IRS disagrees with a proposed response that considered a plan changing a non-PBGC interest rate for involuntary distributions to GATT rates as not violating §411(d)(6). It is not clear why the anti-cutback rule would allow the reduction or elimination of an involuntary distribution but protect the actuarial assumptions used to determine the amount of the distribution.

Proposed response: No, adoption of the default rollover requirement is not a violation of §411(d)(6). The involuntary distribution with a default payment as cash can be eliminated from the plan because the anti-cutback rule does not apply to involuntary distributions except to prevent the use of employer discretion. The prior Q&A on changing the actuarial assumptions for determining the amount of an involuntary distribution cannot be reconciled with this response.

IRS response: The IRS agrees with the proposed answer, that the plan can adopt the default rollover provision, but disagrees that this answer cannot be reconciled with the prior Q&A.

43. §414(l) – Plan Spin-off and Mergers

Company X maintains a §401(k) plan. Subsidiary Y also maintains a §401(k) plan. For valid business reasons, Company X shuts down Subsidiary Y and terminates all of its employees. The Subsidiary Y §401(k) Plan will also be terminated. A few of the Subsidiary Y employees are becoming Company X employees. However, because this is not a severance from employment, these employees can neither receive distribution from the Subsidiary Y §401(k) Plan nor effect a rollover to the Company X §401(k) Plan. Instead, Company X decides that it will do a plan-to-plan transfer of the affected employees' Subsidiary Y §401(k) Plan accounts into the Company X §401(k) Plan. Company X files a Form 5310-A notifying the IRS of the spin-off. After filing the Form 5310-A, Company X decides to wait until the IRS issues a favorable determination letter on the effect of the termination of the Subsidiary Y §401(k) Plan on its qualification before effecting the transfer.

If the Form 5310-A provided that the spin-off would occur as of January 1 or such other time as is reasonably practicable, should Company X (a) file a corrected Form 5310-A saying that the effective date of the spin-off was deferred or (b) do nothing?

Proposed response: None.

IRS response: The IRS noted the plan administrator should not have filed the Form 5310-A, and that the currently pending Form 5310-A can be withdrawn by the plan administrator.

44. §414(p) – Qualified Domestic Relations Orders

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. That is because the distribution is made to the individual in his or her capacity as an alternate payee, not as a participant.

IRS response: The IRS agrees with the proposed answer.

45. §414(q)(2) & §416(i)(1) – Highly Compensated Employee and Key Employee Definition

Is forfeitable stock (i.e., stock that is subject to a substantial risk of forfeiture for purposes of §83) taken into account in determining whether the employee (or any other employee, for that matter) is a 5% owner?

Proposed response: No. One might say that, under §83, until the substantial risk of forfeiture lapses and the stock "vests," the employee doesn't "own" anything yet. See Treas. Reg. 1.414(c)-3, 1.1361-1(b)(3), and 1.1563-2 (restricted stock treated as not outstanding).

IRS response: The IRS agrees with the proposed answer, unless a §83(b) election is made, in which case the employee is treated as owning the stock. The IRS indicated it wasn't clear why the regulations cited in the proposed response were relevant.

46. §414(v) – Catch-up Contributions

A §401(k) plan permits eligible participants to make catch-up contributions. The Plan specifically provides that it does not make matching contribution on catch-up contributions, however, it does specify a matching contributions on elective deferrals other than catch-ups. Elective deferrals and matching contribution amounts are determined on a payroll period basis. In order to facilitate proper crediting of participants' matching contributions, participants to be allowed to make separate elective deferrals for regular (non-catch-up) elective deferrals and catch-up contributions, and these amounts are credited to separate "buckets" on a payroll period basis. If, at the end of the year when all elective deferrals are aggregated to determine which amounts should be considered catch-up contributions, if amounts that were contributed as catch-up contributions are re-characterized as regular elective deferrals, must the employer make matching contributions on the re-characterized amounts?

Proposed response: No. Treas. Reg. 1.414(v)-1(h), example 8, demonstrates that where matching contributions are determined with regard to non catch-up contributions on a payroll period basis, and where separate elections are made on a payroll basis for catch-up and non-catch-up elective deferrals, amounts re-characterized from catch-up to regular elective deferrals at the end of the year do not need to be matched.

IRS response: The IRS noted the plan should be drafted to say what contributions are matched, not what contributions are not matched. Proper plan drafting can eliminate most of these issues. In the situation above, it becomes a plan interpretation question, whether the match does not apply to contributions that are initially made as catch up contributions, or whether the match does not apply to contribution later characterized as catch up contributions.

47. §414(v) - Catch-Up Contributions

A §401(k) plan requires a catch-up eligible participant to affirmatively elect to make catch-up contributions under the plan. The plan is silent with regard to any automatic reclassification of excess contributions as catch-up contributions.

A) If the plan fails the ADP test, may excess contributions made by catch-up eligible participants that did not elect to make catch-up contributions be reclassified as catch-up contributions for purposes of satisfying the ADP test?

B) If the plan satisfies the ADP test by issuing refunds under §401(k)(8), may excess contributions made by catch-up eligible participants that did not elect to make catch-up contributions be reclassified as catch-up contributions before refunds are completed?

C) If the plan is going to satisfy the ADP test by making a qualified non-elective contribution (QNEC) to non-highly compensated employees, may excess contributions made by catch-up eligible participants that did not elect to make catch-up contributions be reclassified as catch-up contributions before the amount of the required QNEC is determined?

Proposed response:

A) No. Treas. Reg. 1.414(v)-1(a)(1) describes catch-up contributions as elective deferrals made by catch-up eligible participants that exceed the applicable limits and are treated as catch-up contributions under the plan. Treas. Reg. 1.414(v)-1(a)(2) allows a plan to provide a single election for catch-up eligible participants, with the determination of whether elective deferrals are catch-up contributions being made under the terms of the plan. Since the plan requires an election from the participant to make catch-up contributions, and such election was not completed, excess contributions cannot be reclassified as catch-up contributions for purposes of satisfying the ADP test.

B) Yes. Treas. Reg. 1.414(v)-1(d)(2)(iii) requires a plan that satisfies the ADP test by refunding excess contributions to reclassify any elective deferrals that are treated as catch-up contributions pursuant to Treas. Reg. 1.414(v)-1(c). Treas. Reg. 1.414(v)-1(c) states elective deferrals with respect to a catch-up eligible participant in excess of an applicable limit under Treas. Reg. 1.414(v)-1(b) are treated as catch-up contributions. Treas. Reg. 1.414(v)-1(b) says the applicable limits are any of the following: i) the statutory limit, ii) employer provided limit or iii) the actual deferral limit. If a plan is satisfies the ADP test by refunding excess contributions, the regulations seem to require a plan reclassify excess contributions as catch-up contributions before any refunds are completed, notwithstanding a plan requirement that the participant make an election to defer catch-up contributions.

C) No. As discussed in Answer A above, excess contributions can not be considered catch-up contributions absent the participant's election to make such contributions. The amount of the QNEC required to satisfy the ADP test must be calculated without reclassifying any excess contributions as catch-up contributions for the participants that did not elect to make catch-up contributions.

IRS response: For the first part of the question, the IRS questioned why the plan would require a catch up contribution election, noting that the regulations would look at treatment of contribution as it is received by the plan. In calculating the ADP, only contributions initially designated as catch up contributions are omitted from the test. Once the ADP test has been failed, other contribution may be characterized as catch up contributions and reduce a HCE's corrective distribution.

If the ADP test is passed, contributions cannot be characterized as catch up contributions. If the contribution is not treated as a catch up contribution when initially made to the plan, it can only be characterized as a catch up contribution to avoid a refund.

If QNECs are made to the plan so that the plan satisfies the ADP test, a contribution can not be characterized as a catch up contribution, since it is not necessary to avoid a refund distribution.

48. §415 – Definition of Compensation

In PLR 200205050, the IRS ruled that compensation, for purposes of §415, includes foreign earned income. Does foreign earned income include compensation of employees of a foreign subsidiary who are not U.S. citizens? If a company wants to include nonresident aliens with no U.S. source income in its ESOP, even though it is not required to do so, is there any way under § 415 regulations that the compensation of these individuals could be anything other than $0, in which case, even one dollar of allocations would disqualify the plan?

Proposed response: Unless there is an ability to impute compensation under §§414(s) and 415, this would seem difficult to do and would make the coverage of nonresident aliens under any qualified plan problematic, especially under Treas. Reg. 1.414(s)-1(f)(1) which appears to provide that imputed compensation works only under a defined benefit plan.

IRS response: The IRS indicated the definition of §415 compensation doesn't seem to have provision for compensation paid to nonresident aliens, and that this issue is being considered as part of a project to update and re-state the §415 regulations.

49. §416 – Top Heavy Plans

What is the date by which a top heavy contribution must be made by when deductibility is not an issue? Does the plan sponsor have 12 months after the allocation date (like a QNEC made to correct an ADP failure) or 30 days after the §404 period ends (like an annual addition)?

Proposed response: The contribution should be made no later than 12 months after the end of the plan year.

IRS response: The IRS was uncomfortable with a 12 month deadline, but was comfortable with 30 days after the §404 deadline for making contributions for deduction purposes, or the Form 5500 filing date.

50. §417 – Disclosure of Relative Value of Optional Forms of Benefit

The final relative value regulations specify two different methods a plan can use to comply with the disclosure requirements for participant and spousal consent, namely that a plan can provide either individualized notices with participant-specific information or a notice with generally applicable information. The general notice requires that actual benefit amounts must be disclosed. Specifically, Treas. Reg. 1.417(a)(3)-1(d)(2)(ii) requires that

> The notice includes either the amount payable to the participant under the normal form of benefit or the amount payable to the participant under the normal form of benefit adjusted for immediate commencement.

Because of timing issues involved in participant retirements, the benefit election and disclosure notices are often provided to participants before all factors used to determine benefit amounts are final, such as compensation. Accordingly, such forms and disclosures often communicate *estimated* benefit amounts. Will the disclosure of estimated benefit amounts satisfy the requirement to disclose actual benefits under the generalized disclosure regime?

Proposed response: Yes. The reference to actual benefit amounts is intended to require individualized benefit amounts for participants under the generalized notice, but does not preclude the use of individualized benefit estimates.

IRS response: The IRS agrees with the proposed answer. It is appropriate to use an estimate for both generalized and individualized notice.

51. §417 – Disclosure of Relative Value of Optional Forms of Benefit

Plan AB was created by a merger of Plan A and Plan B, which used different sets of reasonable actuarial assumptions to determine optional forms of benefit. For certain participants, while they can elect their entire benefit payable in one form, such as a 10 year certain life annuity (10 C&C), will have that benefit determined as the sum of their Plan A benefit converted to a 10 C&C using Plan A assumptions and their Plan B benefit converted to a 10 C&C using Plan B assumptions. How does the plan compare and disclose the relative value of different optional forms in accordance with the regulations? Does the answer change if the plan does separate benefit election forms for the Plan A portion of the benefit and the Plan B portion of the benefit?

Proposed response: None.

IRS response: The plan still needs to a relative value disclosure. The IRS indicated the disclosure would certainly be more work under these facts than the usual plan, but did not offer a prescribed way to make the disclosure.

52. §417 – Retroactive Annuity Starting Date & Administrative Delay of QJSA Explanation

A defined benefit plan is not amended to allow for retroactive annuity starting dates. Due to a miscalculation, a participant does not receive the QJSA explanation and benefit options until one day after the requested annuity starting date.

1. Is the plan administrator required to move the annuity starting date ahead and recalculate benefits payable as of that date?

2. Must a new QJSA explanation be provided using the new annuity starting date?

3. Must plan language allow for moving the participant's requested annuity starting date to accommodate such situations?

Proposed response: 1 & 2) Yes. Because the plan does not allow for a retroactive annuity starting date, a participant can never receive the QJSA explanation on or after the annuity starting date. Thus, the requested annuity starting date must be changed to a later date and the QJSA explanation must be provided prior to this date.

3) If this practice is inconsistent with plan terms, the plan should be amended to reflect the ability to change the annuity starting date for this purpose.

IRS response: The IRS agrees with the proposed answer.

53. §417 – Retroactive Annuity Starting Date & Lump Sum Payment Under Cash Balance Plan

Assume a participant in a cash balance plan that uses a safe harbor interest crediting rate under Notice 96-8 (that is not the 30-year treasury rate) elects a lump sum and received the explanation of the QJSA after the annuity starting date (e.g., a retroactive annuity starting date). The lump sum payable is determined as the cash balance account. How is the lump sum as of the annuity starting date compared to the lump sum as of the distribution date?

Proposed response: The account balance (i.e., lump sum) as of the annuity starting date with interest from the annuity starting date to the distribution date using the cash balance interest crediting rate is payable on the distribution date, assuming no §415 issues limit the benefit further.

IRS response: The IRS agrees with the proposed answer.

54. §417 – Retroactive Annuity Starting Date

Do the final regulations under §417(a)(7) (published in the Federal Register July 16, 2003) revoke the prior regulatory guidance of T.D. 8796, which permitted the QJSA explanation to be provided after the annuity starting date if the actual distribution occurs within 90 days after the QJSA explanation is provided? Or, rather, do the final §417(e) regulations merely clarify the rules for a plan that allows a participant to choose an annuity starting date that occurs on or before the date the QJSA explanation is provided?

Proposed response: The final regulations do not change the prior regulatory guidance of T.D. 8796, but rather additionally permit a plan, if the plan so provides, to allow a participant to choose an annuity starting date that occurs on or before the date the QJSA explanation is provided.

This answer follows from the interaction of Treas. Reg. 1.417(e)-1(b)(3)(iii) with Treas. Reg. 1.417(e)-1(b)(3)(iv). Treas. Reg. 1.417(e)-1(b)(3)(i) sets forth the general rules that require the written explanation be provided before the annuity starting date "except as otherwise provided in paragraphs (b)(3)(iii) and (b)(3)(iv) . . ."

Under the July 2003 final regulations, Treas. Reg. 1.417(e)-1(b)(3)(iii) provides that a plan may permit an annuity starting date to be before the date any affirmative distribution election is made by the participant (and before the expiration of the 7-day period beginning the day after the QJSA explanation is provided), if that distribution commences not more than 90 days after the QJSA explanation is provided (unless later commencement is due solely to administrative delay). Treas. Reg. 1.417(e)-1(b)(3)(iii), as issued in July 2003, merely restates the regulatory rule of the second sentence of Treas. Reg. 1.417(e)-1(b)(3)(ii)(C) as amended 12/18/98 by T.D. 8796.

As issued in July 2003, subsection (b)(3)(iv) lays out the new retroactive annuity starting date rules, which require an affirmative election of an annuity starting date prior to the date the written explanation is provided. The retroactive annuity starting date rules of subsection (b)(3)(iv) say "Notwithstanding the requirements (b)(3)(i) and (b)(3)(ii)..." but do not refer to (b)(3)(iii).

This means that Treas. Reg. 1.417(e)-1(b)(3)(iii) is separate and distinct from the retroactive annuity starting date rule of Treas. Reg. 1.417(e)-1(b)(3)(iv), which requires an annuity starting date affirmatively elected by a participant that occurs on or before the date the QJSA explanation is provided. Treas. Reg. 1.417(e)-1(b)(3)(iii) deals with an affirmative distribution election after the annuity starting date (fixed by the plan) has passed, not an affirmative election by the participant of an annuity starting date that occurs on or before the date the QJSA explanation is provided.

Therefore, Treas. Reg. 1.417(e)-1(b)(3)(iv) would not apply to a situation covered under Treas. Reg. 1.417(e)-1(b)(3)(iii), unless distribution could not commence within 90 days after the QJSA explanation is provided (and later commencement is not due solely to administrative delay) and, as a result, the participant was given the opportunity to choose an annuity starting date that occurs on or before the date the QJSA explanation is provided (assuming the plan permitted retroactive annuity starting dates).

IRS response: The retroactive annuity starting date regulations and the existing rules allowing a benefit election after the annuity starting date are both still available. There can be situations where the timing can be a notice, followed by the ASD, then the election and finally distribution commencement. But the IRS cautioned a time limiter has been added, so there cannot be a lengthy gap between the ASD and the election and distribution. The prior rules could have permitted a lengthy time period between the ASD and the other events in the distribution commencement.

55. § 420 – Impact of employer subsidy on minimum cost requirement

Section 101 of the Medicare Prescription Drug, Improvement, and Modernization Act of 2003 provides for the payment of subsidies to employers that provide certain prescription drug benefits to retirees. Does receipt of the subsidy affect an employer's compliance with the minimum cost requirement under § 420(c)(3)?

Proposed response: No. The subsidy has no effect on the amounts actually paid by the employer. Furthermore, §1202 indicates that Congress intended the subsidy effectively to be ignored for tax purposes.

IRS response: The IRS indicated this issue is being considered for next year's guidance priority list.

56. §423 – Employee Stock Purchase Plans

Can a plan provide that if an employee withdraws from a particular offering period, he is suspended from participating in next following offering period?

Proposed response: No, that would violate the universal availability requirement of §423(b)(4).

IRS response: The IRS agrees with the proposed answer.

57. §451 – Nonqualified Deferred Compensation

Is a participant in a nonqualified deferred compensation plan taxed on the value of the life insurance protection he or she receives, where the death benefit is not limited to the amount of the deferred compensation benefit?

Proposed response: Yes, the participant is taxed under the PS 58 Rules, unless the participant is taxed under the split dollar arrangement rules.

IRS response: The facts of the question are not clear. If the employer purchased the life insurance, the employee is taxed based on table 2001. . If the employer purchased the life insurance and the employee designates the beneficiary, the employee is taxed based on table 2001. This seems the most likely resolution to the unclear facts in this question.

58. §4975(d) – ESOP Loan

An ESOP borrows money for a term of twelve years, and therefore releases shares based on the principal-and-interest method. Three years later, the loan terms are amended and shortened, so that the final payment is due nine years after the initial loan occurred. May the plan thereafter begin releasing the remaining shares on the principal-only method, or must it remain on the principal-and-interest method?

Proposed response: It would be consistent with the purposes of the regulation to permit the change in release methods.

IRS response: The regulations do not address this issue, but the spirit of the regulations would treat the release and allocation in excess of another approved method as permitted.