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SECTION OF TAXATION

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COMMITTEE ON EMPLOYEE BENEFITS

JOINT COMMITTEE ON EMPLOYEE BENEFITS

INTERNAL REVENUE SERVICE

QUESTIONS AND ANSWERS

May 4-6, 2006

The following 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 5, 2006. The statements contained herein cannot be relied on even though they are printed as statements of the IRS. 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. Circular 230

Do the Circular 230 regulations apply to routine plan disclosure documents like summary plan descriptions and S-8 prospectuses?

Proposed Response: No, the Circular 230 regulations do not apply to routine plan disclosure documents like summary plan descriptions or S-8 prospectuses.

IRS Response: The IRS disagrees with the proposed response. Circular 230 regulations apply and best practices should be followed. Qualified plan routine disclosures are not covered opinions.

2. §72 – Separate Contracts

Employer maintains a defined contribution plan that provides for elective deferrals, employee after-tax contributions, and employer matching contributions. The plan has established a separate contract account for the employee after-tax contributions and provides that distributions from the plan will be made first from the employee after-tax separate contract account on a pro-rata basis as permitted under §72. In 2006, employer amends its plan to add a Roth 401(k) feature. All Roth 401(k) contributions will be separately accounted for as required under §402A. The plan is amended to provide that distributions will be made first from the Roth 401(k) account and followed by pro-rata distributions from the employee after-tax separate contract account. Distributions from the “all-other-amounts” account will be the last in the distribution hierarchy.

May the Roth 401(k) account be treated as an additional separate contract account for purposes of §72 and not violate the one separate contract rule of §72(d)?

Proposed Answer: Yes. Section 72(d) would permit a plan to have a Roth 401(k) separate contract account, an employee after-tax separate contract account, and an “all-other-amounts” account without violating the one separate contract rule.

IRS Response: The Roth 401(k) must have a separate account or else it does not satisfy §402A. There is nothing that says that if a plan has a Roth account it can’t also have an after-tax account under §72(d) assuming that it does the required separate accounting. The larger issue is whether §411(d)(6) is violated by the change in the ordering rule. The plan does not have a §411(d)(6) violation if the distribution forms for the participants are not changed. For example, if a person was previously entitled to a lump sum, the person must still be entitled to a lump sum. Section 411(d)(6) does not protect tax treatment and does not protect what accounts the payment can come from, so the employer can change the ordering rule of the accounts.

3. §72(t), §402(e) – Separation from Service

An individual, who is a participant in Corp A 401(k) plan and money purchase pension plan, terminates employment with Corporation A in early 2003 when the individual is 60. The individual is hired by Corporation B, an entity not related to Corporation A, and terminates employment with Corporation B in late 2004. Corporation A rehires the individual after he terminates employment with Corporation B. Until the individual terminates employment with Corporation B, the individual did not intend to return to Corporation A and Corporation A did not intend to rehire the individual. Did the individual have a separation from service after termination with Corporation A for purposes of §72(t)(2)(A)(v) and §402(e)(4)(D)? If the individual had a separation from service, after the individual is rehired, does the individual cease to have had a separation from service?

Proposed Response: Because the individual terminated employment with Corporation A, and neither the individual or Corporation A intended to restore the employment relationship, the individual had a separation from service for purposes of §72(t)(2)(A)(v) and §402(e)(4)(D). After Corporation A rehires the individual, the individual no longer has had a separation from service for the purposes of those sections.

IRS Response: If there was no distribution before rehire, then once the individual is rehired he is treated as though there was no separation from service or termination of employment. If the individual received a distribution before rehire, then there is a separation from service if the termination from Corporation A was bona fide and the employment by Corporation B was bona fide. For purposes of §72(t), there should be no “separation” issue if (as the facts state) the individual is over age 59-1/2. However, if the individual were 55, there would be an issue because there is a special rule in §72(t) for separation from service after age 55.

4. §125 – Mid-year FSA Election Supplements Under Second Plan

In January of 2008, an employer has a calendar year medical plan with a \$200 deductible, and an FSA with a \$1,000 employee salary reduction contribution cap. Both plans are on a calendar year basis. In March of 2008 the employer changes the deductible under the medical plan to \$2,000.

Can the employer create a second FSA (for the same employee group covered by the first FSA) that allows employees to make an FSA salary reduction election of up to an additional \$1,500 for the March through December 2008 period.

Proposed Response: No. Even if the mid-year imposition of the higher deductible represents a significant curtailment of basic medical plan coverage, employees are not allowed to change their FSA elections. The establishment of a second, supplementary FSA plan, mid-year, that is open to additional new employee salary reduction elections, would be an end-run around the FSA election change restrictions, in essence a step transaction that would be collapsed and deemed a prohibited mid-year FSA election change. Treas. Reg. 1.125-4(f)(3)(i).

IRS Response: The IRS agrees with the result in the proposed answer but not the regulation cite. The proper cite is Treas. Reg. 1.125-4(f)(1), which indicates that paragraph (f) does not apply to health FSAs.

5. §125 – Cafeteria Plans: Loss of Coverage

An employee’s dependent under a §125 cafeteria plan suffers from a reduction in benefits for a specific type of medical treatment with respect to which the employee’s dependent is currently in a course of treatment. Pursuant to Treas. Reg. 1.125-4(f)(3)(ii), the cafeteria plan treats the event as a loss of coverage. No similar coverage is available under the cafeteria plan with respect to the dependent’s medical treatment. Can the employee drop family coverage, so that only the employee remains covered under the cafeteria plan?

Proposed Response: Yes. Pursuant to Treas. Reg. 1.125-4(f)(3)(ii), if no similar benefit package option is available, the employee can drop coverage. In this case, the employee can drop dependent coverage so that the employee’s dependent can find coverage that covers the dependent’s medical treatment. However, the employee does not need to drop coverage for himself as well.

IRS Response: The IRS agrees with the outcome of the proposed response, because the question is dealing with real insurance, not an FSA.

6. §223 – Health Savings Accounts

A high deductible health plan (HDHP) has one deductible for prescription drug coverage and a separate deductible for all other medical coverage. Amounts paid toward the prescription drug deductible count towards the deductible for all other medical coverage, but any amounts paid toward the deductible for all other medical coverage do not count toward the prescription drug deductible. The total of the two deductibles does not exceed the statutory maximum contribution limit for the year. What is the maximum contribution amount for the year—the prescription drug deductible, the medical coverage deductible, or the total of the two?

Proposed Response: The total contribution limit amount for the year is the total of the prescription drug deductible and the medical deductible because this amount represents the total amount of out-of-pocket liability under the plan for the year.

IRS Response: The IRS disagrees with proposed response. The HSA contribution limit is the lesser of the statutory maximum or the lowest deductible imposed by the HDHP. The out-of-pocket liability of the individual is not relevant.

7. §280G – Golden Parachute Payments: Disclosure

This issue requires analysis of the shareholder approval exemption for §280G for a private company when the transaction involves:

1. A simultaneous signing of the purchase agreement to sell the company and the closing of the transaction; and
2. The transaction is approved by written consent of stockholders of the seller by the required percentage vote and promptly the company sends “notice of action by written consent of stockholders” (permitted under Delaware General Corporate Law) to all other stockholders to inform them of the action taken.

Under these circumstances, who must receive the 280G adequate disclosure and when must it be furnished?

Proposed Response: The 280G disclosure documents must be provided to the group of stockholders “entitled to vote.” Treas. Reg. 1.280G-1, Q&A-7(a)(2). Because under applicable state law, Delaware General Corporate Law, the sale transaction can be approved by written consent of (more than 75%) less than 100% of the stockholders, the stockholders subject to the written consent are the stockholders “entitled to vote” for purposes of 280G. Before the vote, the 280G adequate disclosures must be furnished to the stockholders subject to the written consent. The written consent must include a separate vote approving the 280G payments.

Alternative Proposed Response: In addition to the above, the 280G adequate disclosure documents must be provided with the “notice of action by written consent of stockholders” to all other stockholders “promptly” after the action is completed.

IRS Response: Notwithstanding the fact that Delaware General Corporate Law permits approval of the transaction by written consent of less than all the stockholders, all stockholders entitled to a vote for

purposes of §280G must be provided with the §280G disclosure notice before the vote occurs. The stockholders needed for approval of the transaction under Delaware Corporate Law do not determine the stockholders who must receive the §280G notice.

8. §401 – Interim Amendments or Remedial Amendment Period?

Question A: Must an individually designed non-safe harbor 401(k) Plan with a plan year ending 12/31, which is on plan cycle C (remedial amendment period ends January 31, 2009) adopt by December 31, 2006 an interim amendment incorporating the final 401(k) regulations that are effective for plan years beginning January 1, 2006? The plan will modify its operations to comply with the final regulation's technical provisions on matters such as calculating gap income and ADP corrective measures.

Question B: Would the answer be different if the company wanted to allow hardship distributions for burial expenses under its safe harbor hardship rules effective for the 2006 plan year?

Proposed Response A: No interim amendment is required. Rev. Proc. 2005-66 only requires interim amendments when a plan qualification requirement changes either due to a statutory change, a regulation, or other published guidance, causing a plan to no longer be qualified. The final 401(k) regulations do not change a qualification requirement, and therefore the technical changes in the regulations may be incorporated into the plan by the end of the remedial amendment period. The IRS has not issued guidance stating that an interim amendment is needed with respect to the final 401(k) regulations. IRS Notice 2005-95 only required amendments if the provisions of the final 401(k) regulations were adopted prior to their effective dates.

Proposed Response B: Yes, an amendment expanding hardship distribution events would be required in 2006 since this is a discretionary provision of the final regulations. This amendment would not have to include the technical changes for the other provisions of the 401(k) regulations since those amendments do not need to be adopted in 2006, but must be adopted by the end of the plan's remedial amendment period.

IRS Response A: The IRS disagrees with proposed response. There is an interim amendment requirement. For Cycle C, the determination letter submission would be in the 12 month period that begins 2/1/08 and ends 1/31/09, however, because the 401(k)/(m) regulations are effective 1/1/2006, an interim amendment is required by the end of 2006 year if it is a discretionary amendment or the end of the 2006 tax filing date if it is a disqualifying provision or integral to a disqualifying provision. Notice 2005-95 clarified that there is an interim amendment requirement to comply with the new 401(k) regulations.

IRS Response B: Adding a hardship distribution for burial expenses is discretionary and the amendment must be adopted by the end of 2006 if it is to be effective in 2006.

9. §401 – Determination Letter Process: Off-cycle Filings

Multiple employer plans are assigned Cycle B. Can a multiple employer plan submit off-cycle? If so, when will they be reviewed?

Proposed Response: A multiple employer plan can submit off-cycle. However, it will not be reviewed until all the in-cycle plans have been reviewed during the year in which the multiple employer plan is submitted off-cycle. For example, if a multiple-employer plan is submitted during Cycle A, it will only be reviewed when all Cycle A plans have been reviewed, unless the employer has an urgent need to obtain an IRS determination letter sooner which is explained in a separate letter or e-mail sent to the IRS

(see question 2 below). The IRS determination letter that will be issued will expire at the end of Cycle B. The multiple-employer plan must be resubmitted in Cycle B in order to have the 5-year extended remedial amendment period with respect to the IRS determination letter that is issued from the Cycle B application.

IRS Response: The IRS is interested in minimizing the number of off-cycle filings. The staggered remedial amendment process is intended to smooth the processing of filings and to allow the IRS to be more responsive. A lot of off-cycle filings could create issues regarding timing, so the IRS suggests making off-cycle filings only if there is good reason. The IRS does not know how many off-cycle filings it will receive so it does not know how long it will take to process them. There is no guarantee that an off-cycle filing will be processed immediately after the completion of all the on-cycle filings. If the volume is high enough, it could conceivably take more than a year to get to off-cycle filings. The IRS is still developing procedures and priorities for off-cycle filings on terminating plans and multiple employer plans, and welcomes input.

10. §401 – Determination Letter Process: Off-cycle Filings

IRS Rev. Proc. 2005-66 says that off-cycle plans will be reviewed after all the in-cycle plans have been reviewed for the year in which the plan is submitted off-cycle. How long could an off-cycle filing be delayed (years)? What can an employer do if an IRS determination letter is urgently needed for a plan? Will there be an expedited review of “urgent” off-cycle filings? For example, an urgent determination letter could be needed due to an unconventional plan design, a merger or acquisition or other transaction, to obtain approval of nondiscrimination testing described in a demonstration attached to Schedule Q, controlled group questions, or other issues for which the employer would want to obtain the comfort of an IRS determination letter approving the Plan, Form 5300, attachments, and various demonstrations submitted with Schedule Q.

Proposed Response: The employer can explain the need for a determination letter in a cover letter sent with the application and also contact the IRS by e-mail or letter sent separately from the application to notify the IRS that an IRS determination letter is urgently needed and why. The IRS will review an application before completing all of the on-cycle plans if the reasons explained in the e-mail or letter warrant an earlier review and issuance of a determination letter. Off-cycle filings will be reviewed no later than the end of the time period for reviewing determination letter requests for the on-cycle period in which the off-cycle request was submitted. The off-cycle request will not be further bumped by subsequent on-cycle determination letter requests submitted in the next year(s).

IRS Response: The general rule in Rev. Proc. 2005-66 is that off-cycle plans will be reviewed after all the in-cycle plans have been reviewed and employers can send letter to explain why a matter is urgent, but the IRS cannot guarantee that this will happen immediately and makes no guarantee on how long it will take. The IRS is not set up to handle email requests for urgent handling of determination letter filings.

11. §401 – Determination Letters: Amendments to Pre-Approved Plans

Section 17.09(3) of Rev. Proc. 2005-66 provides that “if an employer amends an approved M&P plan including its adoption agreement or an approved volume submitter plan to such an extent that the Service determines in its discretion that the plan falls under section 24.03 of Rev. Proc. 2005-16, then the plan will be considered individually designed for purposes of this revenue procedure.” Section 24.03 of Rev. Proc. 2005-16 provides that “the Service may in its discretion determine that [an amended pre-approved] plan is an individually designed plan that will not receive an extended remedial amendment cycle, due to

the nature and extent of the amendments.” When will the IRS take the position that the nature and extent of the amendments have caused an otherwise pre-approved plan to be individually designed?

Proposed Response: The IRS will rarely take the position that the nature and extent of the amendments have caused an otherwise pre-approved plan to be individually designed, but it will do so when the amendments are so significant that the underlying pre-approved document is no longer recognizable.

IRS Response: The IRS basically agrees that it will use discretion and will rarely determine that an amended pre-approved plan is an individually designed plan, except in usual circumstances; however, no formal standards have been set.

12. §401 – Determination Letters: Volume Submitter Plans and Form 5300

The sponsor of a volume submitter plan intends to use its volume submitter plan to restate many of its clients’ qualified plans for EGTRRA as soon as the IRS issues the volume submitter’s advisory letter. The sponsor makes a number of changes to the volume submitter in restating each client’s plan, but the nature and extent of the changes do not cause the plans to be individually designed under Rev. Proc. 2005-16. However, the sponsor determines that it will cost less to file the resulting plans using the Form 5300, rather than the Form 5307, because the statement of changes required to be filed with the Form 5307 submission will cost more to prepare than the difference between the Form 5300 user fee and the Form 5307 user fee. If a plan that otherwise qualifies as a pre-approved plan is submitted using a Form 5300, will the plan be subject to the six-year cycle for pre-approved plans in the current cycle? Will the plan remain subject to the six-year cycle in the next cycle or will it change to the five-year cycle?

Proposed Response: Submitting a plan that otherwise qualifies as a pre-approved plan using a Form 5300 will not, by itself, cause the plan to be an individually designed plan. Accordingly, such a plan is subject to the six-year pre-approved plan cycle in both the current and the next cycle.

IRS Response: The IRS disagrees with the proposed response. The plan cannot stay in the 6-year cycle indefinitely. Unless a plan is submitted within the two-year window for adopting employers to adopt a pre-approved plan, there is no way for the IRS to differentiate between a Form 5300 from an individually designed plan and a 5300 from a modified pre-approved plan. Generally, if a Form 5300 is filed, the IRS will treat the filing as from an individually designed plan and look at the most recent cumulative list and see if it has been updated accordingly. But if submitted within two-year window, then the IRS will treat the plan as a modified pre-approved plan and it will stay in the 6-year cycle for the current cycle, switching to the 5-year cycle for the next cycle.

13. §401 – Determination Letters: Volume Submitter Plans and 30 Employer Requirement

A volume submitter plan sponsor expects that at least 30 employers will adopt plans that are substantially similar in form to its volume submitter. However, the volume submitter plan sponsor also expects that a large number of adopting employers, even though they would be eligible to submit for EGTRRA determination letters using the Form 5307, will instead choose to submit using the Form 5300 because the statement of changes required to be filed with the Form 5307 submission will cost more to prepare than the difference between the Form 5300 user fee and the Form 5307 user fee. If the volume submitter plan sponsor expects that at least 30 employers will adopt plans that are substantially similar in form to its volume submitter, but less than 30 adopting employers will ultimately submit such plans using the Form 5307, does this mean that the volume submitter sponsor cannot certify, as required by Section 9.06(2)(b) of Rev. Proc. 2005-6 and Section 17.02(1) of Rev. Proc. 2005-16, that at least (30) employers will adopt plans that are substantially similar in form to its volume submitter?

Proposed Response: No. Any employer that the volume submitter sponsor expects to adopt a plan that is substantially similar in form to its volume submitter will count toward the 30 employer requirement regardless of whether the employer's plan is submitted for a determination letter using the Form 5300, the Form 5307, or not submitted at all.

IRS Response: The number of adopters is determined at the time the volume submitter is submitted to the IRS. The IRS indicated that it is okay for adopting employers to use either Form 5307 or Form 5300. If it is after the two-year window for adopting employers to adopt a pre-approved plan, the IRS has no way of telling that it is not a regular individually designed plan subject to a different cumulative list.

14. §401 – Determination Letters: Intended Adopters and Form 5300

May an intended adopter sign a Form 8905 – Certification of Intent to Adopt Pre-approved Plan if there is a possibility that the intended adopter's plan will be submitted for an EGTRRA determination letter using a Form 5300 even though the intended adopter's plan is eligible to be submitted using the Form 5307?

Proposed Response: Yes. An intended adopter may, in good faith, sign a Form 8905, even if the intended adopter anticipates that its plan will be submitted using a Form 5300 rather than a Form 5307.

IRS Response: The IRS suggests caution. During the 2-year adoption period, an employer may find it no longer wants to change to another pre-approved plan or individually designed plan. Form 8905 is executed by both the employer and the plan sponsor under penalties of perjury. It should be kept as evidence of the employer's intentions, but would be filed with the Form 5300 if the employer decides to adopt an individually designed plan. This keeps the 6-year cycle at first, and then it will switch to a five-year cycle. However, adoption of more radical plan designs may not get the initial 6-year cycle. Check www.irs.gov section regarding pre-approved plans for more information.

15. §401(a) – General Qualification Requirements

Employer maintains a 401(k) plan for its employees. Employees will receive matching contributions equal to x% for any combination of the first y% of compensation for after-tax/401(k) /Roth 401(k) contributions made by the participant which are not in excess of z% of his or her compensation. In Rev. Rul. 74-55 and 75-56, the IRS ruled that if profit-sharing plan permits a participant to take an in-service withdrawal of after-tax contributions to which "employer contributions are geared" without imposing a suspension period, the plan is subject to disqualification because the withdrawal of employee contributions geared to employer contributions results in the manipulation of the allocation and violation of the definite predetermined allocation formula. Even though these revenue rulings have not been obsoleted or superseded by future guidance, do they still represent the rule under the Code as amended?

Proposed Response: No. Employer contributions "to which employee contributions are geared" are now known as matching contributions. In addition, whether the definite predetermined allocation formula requirement has been satisfied is examined solely on the manner in which employer contributions are allocated under the plan. Subsequent events, such as in-service withdrawals, are not taken into account for this purpose.

IRS Response: The IRS disagrees with proposed response. The rulings are not obsolete, but they are essentially moot with respect to 401(k) and Roth 401(k) money because that money cannot be withdrawn except upon hardship. The rulings still apply to after-tax contributions which are easier to withdraw.

16. §401(a) – Phased Retirement

A partnership sponsors a defined contribution plan. Both partners and common law employees of the partnership participate in the plan. The plan uses a target benefit formula under which the partnership's annual required contribution for each participant is determined based on the individual's account balance, age and compensation. Because it is a partnership, each partner is personally responsible for contributing his or her annual required contribution. All partners are highly compensated as defined in §414(q).

Normal retirement age under the plan is 65. Some partners continue working past age 65 on a full-time or reduced capacity. The partnership would like to amend its plan to allow a partner who attains age 65 a one-time election to cease future participation in the plan, even if the individual works more than 1,000 hours in a year. This election could be made at anytime after attaining age 65, and once made, could not be revoked.

The partnership also sponsors a 401(k) plan in which the partners would continue to participate.

Would a provision in a target benefit plan that allows partners a onetime election to opt out of participation after attaining normal retirement age cause the plan to be disqualified?

Proposed Response: No, such a provision would not disqualify the plan. A plan is allowed to offer eligible employees the option to waive coverage, so long as it passes the §410(b) coverage test. Waiving participation at or after age 65, when a partner might want to work a reduced schedule without the cost burden of contributing for his retirement, would allow the partner a smoother transition from full-time employment to retirement.

No guidance could be found precluding such an election. The proposed regulations on phased retirement recognize that individuals may need to supplement their reduced income with a portion of their retirement savings. For a partner, eliminating the retirement plan contribution will have the same effect as allowing an employee to draw down on their retirement savings; it leaves the partner with more income.

IRS Response: The IRS disagrees with proposed response. This is a cash or deferred arrangement and unless it runs through the §401(k) rules, there is taxable income with respect to the contributions under the arrangement. While it doesn't necessarily disqualify the plan, the 401(k) regulations have detailed rules on the qualification requirements for a cash or deferred arrangement and in this fact pattern the partners have a disqualifying cash or deferred arrangement that would lead to disqualifying the CODA. This is not a good plan design.

17. §401(a), §401(k) – Choice of Opting Out of Defined Benefit Plan

Employer A sponsors both a defined benefit plan and a 401(k) plan which cover all employees after one year of service. Employer A proposes a "soft freeze" of the defined benefit plan; that is, after a certain date newly hired and re-hired employees will not be permitted to participate. Current employees will continue to accrue benefits. New hires and rehires after the freeze date will participate only in the 401(k) plan, but will be provided an enhanced match on elective deferrals. The enhanced match will not be available to employees who continue to accrue benefits under the defined benefit plan. When the freeze commences, Employer A also proposes to allow employees eligible to accrue benefits under the defined benefit plan a one-time, irrevocable choice: continue to participate in the defined benefit plan or opt out of the defined benefit plan and become eligible to receive the same enhanced match on deferrals under the 401(k) plan available to new hires and re-hires. Is this permissible?

Proposed Response: Yes. Giving current employees the option to select continued benefit accruals under the defined benefit plan or an enhanced match under the 401(k) plan does not violate the cash or deferred restrictions under §401(k). That restriction applies to an election by an employee to exchange a benefit accrual under a defined contribution (profit sharing) plan for cash. Here employees are not given a cash option. Instead, their choice is between a benefit accrual in the defined benefit plan or in the 401(k) plan. In addition, a one-time, irrevocable election does not create a “cash or deferred arrangement” within the meaning of the Code. Post freeze, both plans will be subject to coverage and nondiscrimination testing under §410(b) and §401(a)(4).

IRS Response: The IRS agrees with the proposed response. This is not the same kind of problem as discussed in the prior question and the employee election in this situation is not a cash or deferred election because cash is not one of the options.

18. §401(a)(4) – Nondiscrimination Testing; Uniformity Requirements

Treas. Reg. 1.401(a)(4)-3(d)(2) imposes certain consistency requirements when determining accrual rates for general nondiscrimination testing. Treas. Reg. 1.410(b)-5(d)(5) indicates that for average benefit percentage (ABP) testing, employee benefit percentages are determined using the normal accrual rate determined under Treas. Reg. 1.401(a)(4)-3(d)(2). Does this mean that employee benefit percentages for ABP testing must be determined using the same assumptions, measurement periods, and methodology used to determine accrual rates for general nondiscrimination testing, if the plan has to perform both tests? For example, could the general test be an annual test while the ABP test be done using accrued to date accruals? Does the same method of imputing permitted disparity have to be used on both tests, or the same definition of compensation and averaging period?

Proposed Response: The consistency requirement for the general nondiscrimination test and the similar requirement for the ABP test does not mean that both tests must be performed in the same manner. A plan may perform the tests for the same plan year using different assumptions, different measurement periods, and different methodologies for determining accrual rates and employee benefit percentages. The same method of imputed disparity does not have to be used for both tests, and compensation may be determined for the different tests using different definitions of §414(s) compensation and using different averaging periods for such compensation.

IRS Response: The IRS agrees with proposed response. The tests are independent and the consistency requirements do not mandate that they be done the same way.

19. §401(a), §401(k), §403(b) – Severance from Employment

An individual, who is a participant in Corp A 401(k) plan and money purchase pension plan, terminates employment with Corporation A in early 2003 when the individual is age 60. The individual previously worked at the tax-exempt nonprofit parent corporation of Corporation A before transferring to Corporation A, the parent corporation maintained a 403(b) plan, and the individual has a benefit under all three plans. The individual is hired by Corporation B, an entity not related to Corporation A, and terminates employment with Corporation B in late 2004. Corporation A rehires the individual after he terminates employment with Corporation B. Until the individual terminates employment with Corporation B, the individual did not intend to return to Corporation A and Corporation A did not intend to rehire the individual. Did the individual have a severance from employment after termination with Corporation A for purposes of §401(a), §401(k)(2)(B)(i)(I), and §403(b)(11)(A)? If the individual had a severance from employment, after the individual is rehired, does the individual cease to have had a severance from employment?

Proposed Response: Because the individual terminated employment with Corporation A, and neither the individual or Corporation A intended to restore the employment relationship, the individual had a severance from employment for purposes of §401(a), §401(k)(2)(B)(i)(I), and §403(b)(11)(A). After Corporation A rehires the individual, the individual no longer has a severance from employment for purposes of those sections.

IRS Response: The IRS agrees with the proposed response. If the individual received a distribution before rehire, the termination from Corporation A was bona fide, and the employment by Corporation B was bona fide, then there is a severance from employment and a distribution during the period of severance would have complied with the designated qualification requirements. Upon rehire by Corporation A, the individual no longer has a severance from employment and distributions cannot commence. If the individual commences an annuity distribution following severance from employment, and then returns to service, the annuity can continue.

20. §401(a)(9), §417 – Required Distributions and Retroactive Annuity Starting Date

If a defined benefit plan is written to satisfy §401(a)(9) by commencing distributions to all participants no later than the April 1 following the calendar year the participant attains age 70½, are payments while a participant is still employed subject to the retroactive annuity starting date rules under §417?

Proposed Response: No, distributions that commence while a participant is employed to satisfy §401(a)(9) are not subject to the retroactive annuity starting date rules.

The retroactive annuity starting date rules provide to a retired participant whose benefits are delayed the option of (1) a make-up lump sum payment to compensate for the missed payments or (2) actuarially increased future monthly payments. The policy underlying the retroactive annuity starting date rules does not apply to payments made to a participant while employed. Furthermore, it would be unnecessarily complicated to actuarially adjust a monthly benefit while the participant continues to accrue a benefit.

IRS Response: To satisfy §401(a)(9) and §417, payments must start as a QJSA. If starting as a QJSA, the annuity starting date is when the payments start. There is no retroactive annuity starting date in this situation. But it is not clear from the facts whether payments start as a QJSA. If not, then the plan would have to go through the election process under §417 in a timely manner and satisfy §401(a)(9).

21. §401(a)(9) – Required Minimum Distributions Under a Cash Balance Plan

A cash balance plan commences RMDs to a retired employee by paying monthly installments from the plan that satisfy §401(a)(9). Unlike many cash balance plans, the plan does not state that interest credits cease to be credited once RMD payments (or other annuity payments) commence.

How should the continued interest credits be treated under §401(a)(9)? Should the RMD amount be recalculated each December 31, or should the continuing credits be ignored?

Proposed Response: The only viable solution is to ignore the continuing interest credits. The regulations under §401(a)(9) do not permit a re-annuitization in the circumstance described. And the interest credits do not represent new benefit accruals. The plan should be interpreted to lock in the NRB as of the commencement of RMDs, with continued interest credits viewed as actuarial adjustments that are not recognized once annuity-type payments commence.

IRS Response: A cash balance plan must satisfy §401(a)(9) like any other DB plan, which means it must start a non-increasing annuity at the required beginning date. To the extent there are additional accruals, there can be increases attributable to those accruals, but the plan cannot be treated as a defined contribution plan.

22. §401(a)(17) – Limitation on Compensation

Company X sponsors a 401(k) plan for its employees. X's employees can make after-tax and/or 401(k) contributions up to y% of compensation and X will make matching contributions equal to a percentage of such after-tax and/or 401(k) contributions. In an earlier response to a question in a previous year, the IRS indicated that the §401(a)(17) compensation limit did not apply to a participant's 401(k) contributions. Does the §401(a)(17) limit apply to a participant's after tax contributions? For example, assume that for 2006 Employee A has \$1 million in compensation and elects to make 401(k) contributions equal to 3% of his or her compensation. Under Company X's plan, if an employee reaches the 402(g) limit during the year, such participant will be deemed to have elected to make the same percentage of after-tax contributions that s/he made as 401(k) contributions for the remainder of the plan year. Under this scenario, once A's compensation reaches \$500,000, s/he will have made \$15,000 in 401(k) contributions. Can A make \$15,000 in after-tax contributions for the remainder of the plan year?

Proposed Response: The §401(a)(17) limit does not require the suspension of deferrals solely because the participant has received wages equaling or exceeding \$220,000 (for 2006).

IRS Response: Whether the §401(a)(17) limit applies depends on how the plan is written. Section 401(a)(17) provides that a plan can't take into account compensation over \$220,000 (for 2006). If the plan terms provide that participant can't defer more than 6% of compensation, that would be 6% of the §401(a)(17) limit. If the plan is vague and has an election form that allows the participant to elect a percentage, but the actual plan limit is the §402(g) limit, then §401(a)(17) is not a problem. If the plan limit is based on compensation or a percentage of compensation then it is limited by §401(a)(17). There is a special rule in the §401(a)(17) regulations that says how to pro rate the limit over the year, and this rule wouldn't be needed if §401(a)(17) didn't apply for purposes of determining elective deferrals.

23. §401(b) – Retroactive Changes

Does a restated plan have until its applicable EGTRRA cycle to submit for a determination letter on all EGTRRA and non-EGTRRA qualification language (including omissions from plan language)?

Proposed Response: Yes. According to Rev. Proc. 2005-66, Secs. 2.02 and 5.02, Treas. Reg. 1.401(b)-1(b)(3) and 1.401(b)-1(c)(1) provide that a disqualifying provision includes "the absence from a plan of a provision required by or, if applicable, integral to the applicable change in the qualification requirements of the Code, if the plan was in effect on the date the change in those requirements became effective with respect to the plan." Rev. Proc. 2005-66, Secs. 5.03 and 6.03 provide for the extension of the remedial amendment period for disqualifying provisions resulting from omissions of non-EGTRRA qualification language until the end of the plan's initial five-year EGTRRA remedial amendment cycle.

IRS Response: The IRS agrees with proposed response. Rev. Proc. 2005-66 includes a rule that the EGTRRA extension applies to disqualifying omissions from plan language in a plan that was intended, in good faith, to be qualified. Rev. Proc. 2004-25 extended the remedial amendment period to 2005 and Rev. Proc. 2005-66 further extended it to the end of the plan's 5 or 6 year cycle.

24. §401(k), §403(b) – Automatic Enrollment

Corporation A, which maintains the Corp A 401(k) plan, acquires Corporation B, which maintains the Corp B 401(k) plan. After the acquisition, Corporation A desires to automatically enroll the employees of Corporation B in the Corp A 401(k) plan, which allows employees to daily change the percentage of pay the employees contribute under the plan. Corporation A automatically enrolls Corporation B employees in the Corp A 401(k) plan at the same level percentage of pay the employees were contributing to the Corp B 401(k) plan. Therefore, if employee 1 contributed 2% of pay, employee 2 contributed 4% of pay, employee 3 contributed 10% of pay, and employee 4 contributed 0% of pay under Corp B 401(k) plan, then these employees are automatically enrolled at these percentages of pay under the Corp A 401(k) plan. Is the automatic enrollment of employees at different percentages of pay permitted under the Code?

Proposed Response: Yes. The automatic enrollment at different percentages of pay by itself does not violate any provision under the Code, including §401(a), §401(k), and §403(b). A 401(k) plan that uses such an automatic enrollment will need to satisfy the ADP test under §401(k).

IRS Response: The IRS agrees that the automatic enrollment of employees at different percentages is permitted under the Code, but the 401(k) plan must satisfy the ADP test under §401(k) and all the auto enrollment rules. The plan must give the employee the opportunity to change the election just as any other auto enrollment plan must.

25. §401(k), §411(a)(3) – Timing of Forfeiture of Match that Relate to Excess Contributions Under ADP Test

Code sections 401(k)(8)(E) and 411(a)(3)(G) provide in pertinent part that a plan may provide for the forfeiture of matching contributions related to excess contributions under the ADP test (where the ADP test has been failed). When a plan provides for the forfeiture of matching contributions that relate to excess contributions under the ADP test, are such amounts forfeited before or after the ACP test is performed? Assume that the plan is not specific on the treatment of these amounts under the ACP test.

Proposed Response: These amounts are forfeited after the ACP test is performed (i.e., amounts are included in ACP test), as long as this treatment is not inconsistent with the plan document. Under this approach, some of the match associated with the excess contributions might be refunded as part of the excess aggregate contributions after the ACP test is run. Treas. Reg. 1.401(a)(4)-4(e)(3)(iii)(G) provides that each rate of matching contribution is an other right or feature that must be available on a nondiscriminatory basis and that the rate of match is determined after corrections under the ACP test (after any refunds of excess aggregate contributions). This is supported by language in the Internal Revenue Manual, Examination of Cash or Deferred Arrangements, section 4.72.2.9(2) & (3) (March 1, 2002) which provides that if a matching contribution associated with excess contributions is not required to be refunded as an excess aggregate contribution under the ACP test, it should be forfeited (under plan provisions allowing such a forfeiture).

Alternative Proposed Response: These amounts are forfeited before the ACP test is performed (i.e., amounts are not included in ACP test).

There is some support for the answer that such amounts are forfeited before the ACP test is run, as long as this treatment is not inconsistent with the plan document. Treas. Reg. 1.401(m)-2(a)(5)(v) provides that a matching contribution that is forfeited because the contribution to which it relates is treated as an excess contribution is not taken into account for ACP testing. However, it is unclear how this regulation language can be reconciled with the other regulation provision and IRS Examination Guideline provisions discussed above.

IRS Response: Both proposed responses are correct because it is a plan design choice. The plan design must specify the order in which the tests are run and then that order must be followed and this order determines the forfeitures.

26. §402(b), §409A – Taxability of Beneficiary of Nonexempt Trust

Under §402(b), a pension plan is subject to §402(b) “to the extent funded.” Under certain arrangements that resemble US defined benefit plans, accruals may only be partially “funded” at a given time (like US defined benefit plans, they can be under-funded as of a given date). If a plan is partly funded and partly unfunded, even though the intent is to eventually fund the entire arrangement, is an individual participant, while a resident alien in the US, subject partly to the §402(b) rules and partly to the §409A rules? If so, do they have a given yearly accrual that is partly included in income under §402(b) and partly not included in income under §409A (unless the plan fails §409A, in which case that portion of the accrual is subject to income inclusion *and* the 20% additional tax at vesting)? (This possibility adds unnecessary complexity to working in this country. Is there any hope of a clarification or some language throwing the whole plan out of §409A if it is partly funded and intended to be fully funded eventually?)

Proposed Response: Yes, according to the rules and proposed regulations.

IRS Response: The IRS agrees with the proposed response to the extent there is current funding and current inclusion outside of §409A. To the extent there is a future promise to fund, that is subject to §409A.

27. §402(c) – Rollovers to an IRA from Foreign Plan

If a foreign broad-based, funded, pension plan “generally corresponds” to a US qualified plan (e.g., a Swiss or UK plan that has “generally corresponds” approval), can the plan “roll over” into an IRA in the US? The Swiss treaty has language that suggests that an approved “generally corresponding” plan is “deemed” to be a qualified plan, which would give some support to the rollover position.

Proposed Response: No, because an IRA can only take a rollover from a “qualified” plan or another IRA (or a §457 or §403(b) plan, now).

IRS Response: The IRS agrees with proposed response.

28. §402(c), §72(w) – Rollovers and Income from Foreign Plans

If a participant in a foreign broad-based pension plan that generally corresponds to a US qualified plan has the right to “rollover” into a foreign IRA-type plan (Swiss blocked accounts, UK personal pension plan), would the transfer or rollover by a resident alien currently working in the US be included in income under §72(w) or would it remain excluded until actual distribution?

Proposed Response: Moving from one type of retirement-based plan to another retirement-based plan within the same tax jurisdiction does not make the rollover/transfer includible in the participant’s income just because the participant is currently working in the US. Of course, if it is transferred to a non-pension account or trust (e.g., a Jersey “exit trust”) that has no “pension” restrictions (i.e., the money is simply available at the “discretion of the trustee”), the money has been distributed and is includible in employee income.

IRS Response: The IRS agrees that the participant does not get the basis, but does not comment on the second sentence of the proposed response.

29. §404 – Deductible Limit for Small Plans

Section 404(a)(1)(D)(ii) provides that for a plan having 100 or fewer participants for a plan year, unfunded current liability does not include the liability attributable to benefit increases for HCEs resulting from a plan amendment which is made or becomes effective within the last 2 years. Does §404(a)(1)(D) apply in the case of a new defined benefit plan granting benefits based on past service credits?

For example, assume a new calendar year DB plan is started effective 1/1/2006 and grants past service for benefit accrual purposes. For purposes of §404(a)(1)(D)(ii), is the adoption of a new plan considered an amendment subject to the two-year restriction or may the full UCL be deducted?

Proposed Response: Adoption of a new plan is not considered to be an amendment for this purpose. The conference agreement to EGTRRA, which added §404(a)(1)(D)(ii), indicates that “termination liability does not include the liability attributable to *benefit increases* for highly compensated employees resulting from a plan amendment. . .” [emphasis added] The reference to benefit increases would not encompass plan commencements granting past service credits.

IRS Response: Section 404(a)(1)(D) applies to the adoption of a new plan as well as a benefit increase in an existing plan.

30. §404(a) – Contribution Deduction Limits

A partnership sponsors a profit sharing plan covering the self-employed partners as well as employees of the partnership. The contribution on behalf of one partner exceeded 25% of the partner’s earned income, as defined in §401(c)(2). However, contributions on behalf of all beneficiaries under the profit sharing plan, including partners, did not exceed 25% of the compensation otherwise paid or accrued during the taxable year. Is the contribution on behalf of the partner deductible?

Proposed Response: Yes. The deductibility limit is not calculated separately with respect to each self-employed partner. Under §§401(c)(4) and 404(a)(8), self-employed partners are treated as employees of the partnership with respect to which the plan is established.

IRS Response: The IRS agrees with proposed response. The deductibility limit is calculated on the partnership as a whole.

31. §404(a) – Contribution Deductions

A lawyer established a professional corporation (PC). The PC is a partner in a law partnership. The PC and the law partnership are in an affiliated service group under §414(m). The lawyer participates in a profit sharing plan for employees and partners of the law partnership and its affiliates. The contribution on behalf of the lawyer exceeded 25% of the lawyer’s compensation from her PC. However, contributions on behalf of all beneficiaries under the profit sharing plan did not exceed 25% of the compensation otherwise paid or accrued during the taxable year. Is the contribution on behalf of the lawyer deductible?

Proposed Response: Yes. Although the lawyer performs services for/with the law partnership through the lawyer’s PC, the situation is substantially similar to the situation in the question above. Under

§§401(c)(4) and 404(a)(8), self-employed partners are treated as employees of the partnership with respect to which the plan is established. Thus, the deductibility limit is not calculated separately with respect to each self-employed partner, or, in this case, with respect to the lawyer's PC.

IRS Response: The IRS disagrees with proposed response. Section 414(m) regarding affiliated service groups does not apply for deduction purposes. There is no aggregation of a deduction to determine whether the contributions are over 25% in the aggregate. Here, the individual PC would have a problem with the deduction limit.

32. §409A – Nonqualified Deferred Compensation: Mid-year Cessation of Deferral Election

Why does Prop. Treas. Reg. 1.409A-2(a) prohibit a prospective, mid-year cessation of a deferral election under a nonqualified deferred compensation (“NQDC”) plan other than as a result of the occurrence of an unforeseeable circumstance or in coordination with a deferral election under a qualified plan?

Proposed Response: There is nothing in Code §409A in general, or in §409A(a)(4) in particular, that would mandate the prohibition on mid-year cessation of deferral elections in general. That Code section merely states when elections must be made. Similarly, there is nothing in the legislative history that would mandate such a regulation.

Q&A #20 of IRS Notice 2005-1 set forth a transition rule for 2005 that allowed NQDC plans to adopt an amendment to allow cessation of deferrals in 2005 (but not in later years), provided the plan were so amended by December 31, 2005. There is likewise no support in the statute or its legislative history for this transition rule and its limited applicability to 2005 only.

A mid-year cessation of deferrals, which is prospective only and which is irrevocable for the duration of the year, does not involve any acceleration of payments under the NQDC plan. Any argument to the contrary can only be based upon the notion that future deferrals constitute assets of the NQDC plan that are subject to Code section 409A's distribution rules - a concept that is contrary to the plan asset regulations under ERISA (which do not technically apply to NQDC plans by reason of 29 CFR 2520.104-23) and common sense.

From a tax policy standpoint, the prohibition makes little sense. The main evil that §409A addresses is the easy availability of NQDC benefits to key executives (or a preference favoring key executives) at a point where the plan sponsor is insolvent or nearly so. A mid-year termination of a deferral election results in (1) less money being contributed to the NQDC plan; (2) more money being subject to the claims of the key executives' creditors; and (3) more federal income taxes being paid on current compensation.

IRS Response: The IRS disagrees with proposed response. The regulations say it is not a question of whether or not the future deferral is a plan asset. The process of changing the deferral election in the middle of the year changes the timing of when someone receives the money and that is a violation of §409A.

33. §409A – Nonqualified Deferred Compensation: Permissible Distribution Event

An arrangement made at the time of deferral provides for the payment of deferred compensation upon the service provider's termination of employment with the service recipient. The arrangement provides for payment of objectively determinable amounts pursuant to a fixed schedule. However, the arrangement provides for multiple fixed schedules depending on the reason for the service provider's termination.

Is it permissible to have different payment schedules where the distribution event is termination from employment but the reason for termination differs?

Proposed Response: The arrangement complies with the requirements of §409A in all respects. The distributions are made upon a permissible distribution event and the fixed schedules are specified under the plan at the time of deferral.

IRS Response: The IRS disagrees with proposed response. The proposed regulations require a single payment date on a separation from service. However, the IRS will treat this as a comment on 409A.

34. §410 – Exclusion of Employees

In the Quality Assurance Bulletin (“QAB”) issued February 14, 2006, the IRS revisits the issue of the exclusion of certain employees under §410(a). The QAB provides, by way of example, that it would be permissible to exclude from participation the class of employees which constitutes “the substitute workforce of the Employer, as distinguished from regular full-time and part time employees, that is a separate employment classification based on availability to work.” Is it, therefore, the position of the IRS’s Employee Plans Division that certain employees that make up an employer’s non-regular or substitute workforce, such as “on-call,” “per diem,” and “temporary” employees, may be properly excluded from participation consistent with §410(a) as part of an employment classification that is defined by a factor such as availability to work and is not defined by an impermissible service requirement?

Proposed Response: Yes, members of an employer’s non-regular or substitute workforce, such as “on-call,” “per diem,” and “temporary” employees, may be properly excluded from participation consistent with §410(a) as part of an employment classification that is defined by a factor such as availability to work and is not defined by an impermissible service requirement.

IRS Response: The QAB does not reflect a change in official position of the IRS because it is not official guidance and there has been no change of position in the QAB. It merely reflects a procedural change in the way classification exclusions will be handled in determination letter submissions. Additional clarifying language may be required if a plan provision could result in the exclusion of an employee that completes a year of service. If the plan defines an exclusion class without a reference to service, then it will not be challenged during the determination letter process. An example in the QAB excludes part-time employees, but if the part-time employees have 1,000 hours or more, they are covered by the plan, but if the plan defines part-time employees as employees “scheduled” to work less than 1,000 hours, the language would have to be changed. The IRS noted that determination letters are being issued with a caveat that a plan can’t rely on a determination letter with respect to whether an exclusion classification violates §410. On-call employees generally fit into the definition of substitute workforce. Temporary employees probably are not a class that can be excluded. Per diem employees are not that clear. It depends on the facts and circumstances. This issue is an examination issue looked at during audit. The label may be irrelevant if the provision effectively imposes a service condition. (See Pub. 794).

35. §410 – Exclusion of Employees

The IRS issued a Quality Assurance Bulletin (“QAB”) dated February 14, 2006, dealing with plan exclusions of part-time, temporary, and seasonal employees. Does the QAB prohibit the exclusion of all categories of employees that are defined based on a service requirement? For example, hospitals frequently have an employment category known as “PRN.” The category is comprised of nurses who

work on an on-call basis and have a contract with the hospital that excludes them from receiving benefits. Does the QAB prohibit the exclusion of PRN's from a plan? Is it permissible to exclude interns from plans maintained by law firms?

Proposed Response: A plan may only exclude a category of employees that is defined on some basis other than service. If frequency or timing of service is the only factor that distinguishes one group of employees from the remainder of the workforce, then that category may not be excluded. The only exception is that a plan may exclude a category of employees based on service if the plan provides that anyone in the excluded category will be eligible if they work more than 1,000 hours in an eligibility service computation period. PRNs may not be excluded, unless the plan provides an exception for PRNs who work more than 1,000 hours in an eligibility service computation period.

Examples of permissible exclusions are all employees that work in Unit A or all hourly-paid employees. With respect to the law firm interns, it would be permissible to exclude interns if the firm employs interns throughout the year. It would not be permissible to exclude summer interns, unless the plan provides an exception for summer interns who work more than 1,000 hours in an eligibility service computation period.

IRS Response: It may be possible to exclude some of these employee classifications, but the IRS may require additional language to clarify any ambiguity regarding whether employees that work 1,000 hours or more are included in the plan. There will not be an extensive review during the determination letter process. The issue of excluding classifications of employees will be looked at during audit.

36. §410(b), §401(k) – Otherwise Excludable Employees

How is the otherwise excludable group determined under a 401(k) safe harbor plan that allows deferrals immediately, but requires one year of service to qualify for the safe harbor match.

Proposed Response: The otherwise excludable group includes all participants who were hired during the plan year or who terminated during the plan year before qualifying for the match. It does not include participants who were not yet eligible for matching contributions at the beginning of the plan year, but completed the one-year service requirement later in the plan year. For example, if a participant in a calendar-year plan completes one year of service on April 1, and therefore qualifies for matching contributions on deferrals made between April 1 and December 31, then he or she should be treated as having been in the safe harbor plan for the entire plan year. As a result, none of the participant's deferrals -- whether made before or after April 1 -- will be included in the ADP test for otherwise excludable employees, and the safe harbor plan will be deemed to have met the safe harbor matching requirement for the full plan year with respect to any such participant.

IRS Response: The IRS agrees with the proposed response, but noted that the response seems to suggest that you don't test the separate plan for under 21 and less than one year of service group. The IRS clarified that the under 21 and less than one year of service group must be tested (ADP, ACP) even if the test is probably easily passed because there aren't that many HCEs in the group who are under 21 and one year of service.

37. §410(b)(4) – Otherwise Excludable Employees

Does the otherwise excludable employee rule include employees who would be excluded under the maximum permissible entry dates? For example, consider a calendar year plan with no minimum service

requirement and monthly entry dates. When testing such a plan for the 2006 plan year, are only employees hired after December 1, 2005 excluded or are employees hired after July 1, 2005 excluded?

Proposed Response: While neither Treas. Reg. 1.410(b)-6(b)(3) nor 1.410(b)-7(c)(3) mention entry dates, §410(b)(4)(C) and Treas. Reg. 1.410-6(b)(1) incorporate entry dates into the maximum age and service exclusions. Accordingly, when determining the otherwise excludable employees, a plan may determine such group using bi-annual entry dates. A calendar year plan may exclude all employees hired after July 1, 2005.

IRS Response: The IRS notes that they are working on this issue, and they do not currently have an answer. The issue has come up on examination several times.

38. §411(d)(6) – Anti-cutback Rule and Elimination of Optional Forms of Benefit

A plan is using the core options approach under the recently finalized §411(d)(6) regulations to eliminate various non-core optional forms. Would the following options satisfy the requirement to provide a core joint and 75% contingent annuity option?

- a) A 75% joint and contingent annuity that reduces on the first death of the participant or contingent annuitant?
- b) A 75% joint and contingent annuity that reduces only on the participant's death but has a "pop up" feature under which the amount payable returns to the single life annuity amount if the contingent annuitant dies first?
- c) A 75% joint and contingent annuity with a cash refund feature?
- d) A 75% joint and contingent annuity with a guaranteed term certain?

Proposed Response: A 75% joint and contingent annuity that reduces upon first death can be the core 75% joint and contingent annuity. None of the other 75% joint and contingent annuities can be the core 75% joint and contingent annuity. Although Treas. Reg. 1.411(d)-3(c)(3)(ii)(B) notes that such features do not prevent such options from being in the same family as a 75% joint and contingent annuity without such features, they do prevent options with such features from serving as core options.

IRS Response: This is Question 23 from the 2006 Enrolled Actuaries' Gray Book. Only the first option works. The other options involve similar annuities with other features that don't satisfy the requirements for core options under the regulations.

39. §411(d)(6) – Anti-cutback Rule and Elimination of Optional Forms of Benefit

Many plans have frozen optional forms (optional forms that were prospectively eliminated as of some prior date but still apply to the accrued benefit as of that date as required to comply with §411(d)(6)), often as a result of merging plans with different options. Participants electing a frozen option may receive the remainder of their benefit in any ongoing option offered by the plan. For purposes of sorting options into families when using the redundant options rule, some have asked whether the two pieces of the benefit can be evaluated separately, or whether each frozen/ongoing option combination needs to be considered its own separate family for this purpose.

For example, a non-contributory plan may provide a lump sum option to participants in merged plan A with respect to their accrued benefits at the 12/31/95 merger date. Participants electing to receive their 12/31/95 accrued benefits as a lump sum may receive their post-1995 accruals in any ongoing annuity form offered by the plan, including any one of four options in the family of joint and contingent annuity options with various continuation percentages between 50% and 100% (e.g., 50%, 66-2/3%, 75%, or

100%, all actuarially equivalent). May the employer eliminate the 66-2/3% joint and contingent annuity option using the redundant distribution option approach under the §411(d)(6) regulations?

Proposed Response: Yes. The 66-2/3% joint and contingent option is a separate optional form of benefit than the frozen lump sum distribution; they are not combined into a different optional form or used to create a new family of distribution options.

If the plan's annuity benefits paid on the residual benefit after distribution of the lump sum is a combined distribution option or part of a separate family, then it cannot be eliminated using the §411(d)(6) regulations. If the annuity/lump sum is a combined optional form of benefit, it is a separate family from the families specified in Treas. Reg. 1.411(d)-3(c)(4) and cannot be eliminated using the redundant distribution option approach. Similarly, if the annuity/lump sum is a combined optional form of benefit, it cannot be eliminated for any participant until the lump sum is less than 25% of the value of the participant's entire benefit. Treas. Reg. 1.411(d)-3(d)(2)(iii). Note that eliminating just the 66-2/3% joint and contingent annuity option does not affect the participant's ability to elect distribution of the frozen lump sum benefit.

Treating the lump sum and the 66-2/3 joint and contingent annuity as separate optional forms is consistent with the proposed §415 regulations, which would treat the distribution of a frozen lump sum and a residual annuity as separate distribution options for purposes of the QJSA exclusion (Prop. Treas. Reg. 1.415-1(c)(4)(ii)(B)) and the multiple annuity starting date rules, if the lump sum and joint and contingent annuity have different annuity starting dates (Prop. Treas. Reg. 1.415-2(a)(1)). Any other interpretation would preclude a plan that had a frozen lump sum benefit from ever simplifying or eliminating any other distribution options under the §411(d)(6) regulations.

IRS Response: This is Question 27 from the 2006 Enrolled Actuaries' Gray book, but the proposed answer is different from the gray book answer. The IRS disagrees with this proposed response. Each combination of forms is a separate family. There is a similar question in the relative value regulations and they will consider this question as they finalize the §411(d)(6) regulations.

40. §411(d)(6) – Anti-cutback Rule and Cost of Living Adjustments

Plan provides cost of living increases for all participants whose benefits have commenced. After commencement, a participant's benefit is increased annually by the increase in CPI with a maximum annual increase of 5% per annum. Effective January 1, 2006, the sponsor has decided that the cost of living feature in the plan is too expensive and wants to eliminate this feature with respect to future accruals. One approach would be to use the A+B approach, where A is the participant's January 1, 2006 accrued benefit with the pre-amendment COLA and B is future accruals under the plan with no COLA.

In lieu of the A+B approach outlined above, would it be acceptable to amend the plan to provide that a participant's benefit payable under the plan will be equal to the benefits provided under the B formula based on all years of service with the company with no COLA, however in no event will the participant receive a monthly benefit less than what would have been received under the plan provisions as of January 1, 2006 based on the participant's accrued benefit as of January 1, 2006 with the COLA continuing into the future? To illustrate this approach, assume the accrued benefit as of January 1, 2006 is \$1,000 per month under the A formula based on service as of January 1, 2006 and is \$1,200 per month at retirement under the B formula based on all service at retirement. The participant would receive \$1,200 per month until the \$1,000 January 1, 2006 benefit, adjusted for inflation, exceeds \$1,200. At that point, the participant would receive the adjusted January 1, 2006 benefit.

Alternatively, would it be acceptable to amend the plan to eliminate the COLA feature and increase the participant's benefit as of January 1, 2006 so that it is actuarially equal in value as of January 1, 2006 to

the participant's accrued benefit with the COLA projected into the future at an assumed rate for future years?

Proposed Response: Either approach is acceptable. Under the first approach, the participant receives a monthly payment that is not less than the monthly benefit accrued as of January 1, 2006, which complies with §411(d)(6). Under the second approach, the plan has multiple amendments with the same effective date – one to prospectively eliminate the COLA and another amendment to convert the existing benefit to an actuarially equivalent benefit without a COLA. These two amendments do not decrease the participant's accrued benefit, and therefore complies with Treas. Reg. 1.411(d)-3(a)(2)(ii).

IRS Response: This question touches on §411(d)(6) issues with respect to COLAs. A plan can use an A+B approach and give COLA on that benefit at that time, but future benefit accruals have no COLA. The second acceptable alternative is to do a wearaway. Look at the greater of the frozen benefit with the COLA versus the ongoing benefit formula without any COLA. The last alternative in the proposed response, which gets rid of the COLA and increases the benefit going forward so it is actuarially equivalent to the accrued benefit with the projected COLA, is not acceptable. This alternative violates the rule that the COLA is a protected piece of the accrued benefit as of a particular point in time and it cannot be removed. But a plan could offer this alternative as an optional form.

41. §414(q) – Highly Compensated Employees

Does the increased compensation limit of \$100,000 (effective as of January 1, 2006) apply in determining who is a highly compensated employee (“HCE”) for purposes of a 2006 calendar year plan year? In other words, are HCEs determined for a 2006 calendar year plan year by identifying all employees with compensation in excess of \$100,000 in 2005, or does the \$95,000 threshold that was effective in 2005 apply in making this determination?

Proposed Response: Per §414(q), the increased compensation limit of \$100,000 should apply in identifying HCEs for a 2006 calendar year plan year.

Section 414(q)(1) provides in pertinent part that the term “highly compensated employee” means “any employee who (A) was a 5-percent owner at any time during the year or the preceding year, or (B) for the preceding year (i) had compensation from the employer in excess of \$80,000.” Section 414(q)(1) further provides that “[t]he Secretary shall adjust the \$80,000 amount under subparagraph (B) at the same time and in the same manner as under §415(d), except that the base period shall be the calendar quarter ending September 30, 1996.”

As authorized by §414(q)(1), Notice 2005-75 provides, in relevant part, that “[e]ffective January 1, 2006, the limitation on the annual benefit under a defined benefit plan under §415(b)(1)(A) is increased from \$170,000 to \$175,000. [. . .] The Code provides that various other dollar amounts are to be adjusted at the same time and in the same manner as the dollar limitation of §415(b)(1)(A). These dollar amounts and the adjusted amounts are as follows: [. . .] The limitation used in the definition of highly compensated employee under §414(q)(1)(B) is increased from \$95,000 to \$100,000.”

Based on the plain language of the statute and the effective date specified in Notice 2005-75, the dollar limit under §414(q) on and after January 1, 2006 is \$100,000 and, as a result, an HCE in a 2006 calendar year plan year is an employee who had compensation from the employer in the preceding year (2005) in excess of \$100,000. Hence, per the plain language of the Code and Notice 2005-75, the applicable HCE dollar limit for a 2006 calendar year plan year, i.e., the HCE compensation limit for the preceding year, should be \$100,000.

Some practitioners take a contrary view and assert that the \$95,000 limit applies for the determination of the HCEs in a 2006 calendar year plan year. This position appears to be based primarily on an IRS Information Letter dated December 9, 1999. However, that letter pre-dates the most recent revision of §414(q) and addresses the HCE determination issue solely with reference to a non-calendar year plan. While it appears that the 1999 letter is correct in that it provides that the applicable limit is the one in effect when a plan year begins, rather than the limit in effect when a plan year ends, we believe the message of this letter has been misinterpreted in the application thereof to calendar year plan years, in which the first and the last day of the plan year fall in the same year. In any case, such letter cannot take precedence over the plain language of the statute.

IRS Response: The IRS disagrees with proposed response. \$95,000 is based on the cost of living in 2005 and this threshold is what should be used to determine HCEs for 2006. The IRS has a guidance project on §414(q) and will consider this question as a comment.

42. §414(v) – Catch-up Contributions

Can a plan, on a payroll-by-payroll basis, require catch-up eligible participants to contribute a minimum percentage in order to make catch-up contributions for the payroll period so long as the imposition of this requirement would not prevent such a participant from making the allowable catch-up contributions up to the statutory limit?

Treas. Reg. 1.414(v)-1(e)(1)(i) provides that applicable employer plans that offer catch-up contributions and that are otherwise subject to §401(a)(4) must not have employer-provided limits that prevent any catch-up eligible participant from having an effective opportunity to make the same dollar amount of catch-up contributions as other catch-up eligible participants. In other words, plans may not have any employer-provided limit that applies to catch-up eligible participants and that prevents such participants from making elective deferrals in excess of the employer-provided limit.

For example, could a plan require a catch-up eligible participant to contribute at least 6% of compensation in a payroll period as a condition to being able to make a catch-up contribution for that payroll period? Because no catch-up eligible participant would be precluded from contributing 6% in each payroll period given the limits of §§401(a)(17) and 402(g) (i.e., 6% of the 2006 compensation limit of \$220,000 is less than the 2006 §402(g) limit of \$15,000), the imposition of such a requirement would not prevent a catch-up eligible participant from making allowable catch-up contributions up to the statutory limit. Each catch-up eligible participant is able to satisfy this requirement, and therefore, able to make the allowable catch-up contributions.

Proposed Response: Yes, as long as such a requirement alone or in conjunction with any other plan provision does not prevent any catch-up eligible participant from making catch-up contributions up to the statutory limit. A minimum percentage under which it is impossible to contribute that percentage each payroll period without exceeding §402(g)'s limit would be considered a requirement that prevents a catch-up eligible participant from contributing up to the statutory limit.

IRS Response: The 6% threshold in the example is not a plan contribution limit; it is used only to determine eligibility to make catch-up contributions. Catch-up contributions are contributions in excess of the plan limit (here, the §402(g) limit and not the 6% limit). Because the plan provides that participants can only make catch-up contributions when they defer 6%, this provision does not satisfy the universal availability requirement. The regulations provide that if a plan has a limit it can pro rate the catch-up contributions over the year, but because 6% of compensation is not the plan limit it can't be used to pro rate the catch-up contributions over the year.

43. §417 – Retroactive Annuity Starting Date: Disability Pension Payments

Some multiemployer pension plans offer disability pension benefits that are retroactive to the date of the disability or to the seventh month of disability as determined by the Social Security Administration. These plans authorize the payment of the “retroactive slice” of the disability benefit in the form of a lump sum. The amount of the disability pension is the same as the regular pension but reduced by the lesser of \$1.00 or 1% of the regular pension. Thus, for general purposes, this benefit is not auxiliary and the QJSA disclosures and elections are made at the time the disability pension is awarded. However, the “retroactive slice” may not be auxiliary. Do the retroactive annuity starting date regulations which took effect July 1, 2004, apply to such “retroactive slice”?

Proposed Response: No, because the “retroactive slice” of the disability pension payments is auxiliary the retroactive lump sum payment is not subject to the retroactive annuity starting date regulations. Although the disability pension generally would be considered non-auxiliary because it is slightly less than the regular pension, the “retroactive slice” is auxiliary for the following reasons. First, the amount of the disability benefit does not change based upon the age of the participant or date the benefit commences. Second, the retroactive annuity starting date regulations require retroactive interest only after normal retirement age, and the disability benefit would not have a benefit commencement date on or after normal retirement age.

IRS Response: The IRS disagrees with proposed response. The entire disability benefit is not auxiliary so a plan has to look at the entire benefit going forward, including the retroactive lump sum disability piece as being subject to the retroactive annuity starting date regulations.

44. §417(e) – Applicable Interest Rate

A qualified defined benefit plan provides lump sum benefits for employees eligible for early retirement, providing a lump sum benefit that is the larger of:

- (i) The present value of the immediate early retirement benefit, calculated using the plan’s general basis for actuarial equivalence -- the applicable mortality table and 7%, and
- (ii) The present value of the participant’s normal retirement benefit using the §417(e) applicable mortality table and the applicable interest rate.

Does this plan meet the minimum lump sum requirements of §417(e)?

Proposed Response: Yes. Treas. Reg. 1.417(e)-1(d)(1) indicates that the amount of any distribution must not be less than the amount calculated using the applicable interest rate and mortality table, and this requirement is satisfied by providing no less than the present value of the participant’s normal retirement benefit valued using the applicable mortality table and applicable interest rate. Additionally, the court in *Rybarczyk v TRW* specifically held that providing the better of a lump sum based on the normal retirement benefit valued using §417(e)(3) assumptions or a lump sum based on the subsidized early retirement benefit valued using plan assumptions does not violate ERISA or the Code. The possibility that a subsidized early retirement annuity benefit would play a role in the calculation did not create a separate optional form that must be valued using §417(e)(3) assumptions, but “merely provided for the possibility of some icing on the early retirement cake—and we are aware of nothing in ERISA, the Code, or the regulations that can fairly be said to make such a bonus problematic in any way.”

IRS Response: The IRS disagrees with the proposed response and indicated the regulations provide that if a plan pays a lump sum for the early retirement benefit, then it must apply §417(e) to the calculation of the lump sum. The IRS did not indicate a citation for that requirement. The IRS was not involved in the case cited and did not brief the court on its interpretation of the regulations.

45. §417(e) – Applicable Interest Rate and Options After Plan Merger

Two qualified defined benefit pension plans are merging in order to reduce actuarial valuation and compliance filing costs. The benefit structure for each plan is to be maintained for its applicable group of participants within the merged plan, and the established individual benefit calculation systems for each plan are to remain separate. Both plans pay lump sums and other options subject to the minimum value requirements of §417(e)(3). However, the two plans use different stability and lookback periods to determine the applicable interest rate.

Can the use of different stability and lookback periods for the two groups of participants be continued under the merged plan? Or must an amendment be in effect no later than the merger date to provide a single stability period and a single lookback period for the plan as a whole, with appropriate transition under Treas. Reg. 1.417(e)-1(d)(10) and with appropriate modification of calculation systems?

If the use of different stability and lookback periods can be continued under the merged plan, can the plan use a single applicable interest rate for the calculation of relative values regardless of the applicable interest rate that applies to a specific participant?

Proposed Response: A plan must have one plan-wide stability period and one plan-wide lookback period for purposes of the minimum value requirements of §417(e)(3). It cannot have one stability period and one lookback period for one group of participants and a different stability period and/or different lookback period for another group of participants. Treas. Reg. 1.417(e)-1(d)(4)(i).

The transition provisions of Treas. Reg. 1.417(e)-1(d)(10)(ii) are applicable and should be followed. Therefore, in the case of the envisioned merger, compliance with this requirement will necessitate a plan amendment effective on or before the date of plan merger, with a transition period that extends from the merger date to one year after the later of the adoption date or the effective date of the plan amendment.

Relative values for §417(e)(3) options must be calculated using the plan's one plan-wide applicable interest rate. If the plan contains alternative, reasonable assumptions for the calculation of §417(e)(3) option amounts, such alternative assumptions can be used for the relative value illustrations for a particular individual if those alternative assumptions produced a larger benefit and are therefore actually "driving" the benefit amount for that individual.

IRS Response: A plan can maintain a better benefit by having a lower interest rate for one of the groups, but satisfaction of the statutory requirements is based on the use of a single rate for the entire plan.