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Pre-Retirement Qualified Plan Pay-Outs Under ERISA

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PRE-RETIREMENT QUALIFIED PLAN PAY-OUTS UNDER ERISA*

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INTRODUCTION

No one can deny that the law of deferred compensation and retirement plans qualified under section 401 of the Internal Revenue Code is a burgeoning field, at least since the passage of the Employee Retirement Income Security Act ("ERISA") in 1974. One of the most complicated, yet recurring problems, in this broad area is that of pre-retirement payouts. At the same time this topic is among those which have seen the most changes from pre-ERISA law and probably its practice. Hence, this Article attempts a survey of pre-retirement payouts from qualified (retirement and deferred compensation) plans under the post-ERISA tax law, when an employee receives distribution from an existing, and continuing, qualified plan, whether on account of termination of employment or otherwise. No attempt is made to explore the myriad complexities which confront employees and employers alike when the qualified plan itself is terminated, save in the context of the limited portability provided by Congress in the "Rollover" or "Conduit" individual retirement arrangements.

This Article is divided into three parts. The first considers the rules applicable to lump-sum distributions and forfeitures upon termination of employment, as well as available methods of structuring payouts in such circumstances. The second part explores alternatives for deferring taxation on the amount distributed to a terminated employee. Finally, the Article will focus on the rules governing in-service withdrawals by employees.

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1 This Article was originally given as an address to the Alabama Tax Institute, 1977.
3 For an examination of some of the problems arising when a qualified plan is terminated, see Manch, Tax Questions on Qualified Plan Terminations, Mergers, Acquisitions, and Other Transfers, 35 N.Y.U. Inst. on Fed. Tax. 1 (ERISA Supp. 1977).
4 See notes 90-170 and accompanying text infra.
I. TERMINATION OF EMPLOYMENT: LUMP-SUM DISTRIBUTION AND FORFEITURES

The type of plan making the distribution is perhaps the most significant practical factor in determining the form and timing of distributions to a terminated employee. Also basic to this area is the concept of vesting; as a practical matter only vested benefits, or to use ERISA terms, nonforfeitable accrued benefits, are distributed to terminated employees. 5

A. Defined Benefit Plans

Many defined benefit plans 4 provide that payment to a terminated participant of his nonforfeitable accrued benefit will be deferred until his normal retirement age. If, however, a plan provides for early retirement, and a terminated participant has already satisfied any service requirement for early retirement, but not any age requirement, he must be permitted to elect, upon satisfaction of such age requirement, early retirement benefits as if he were still an employee. 7 If the participant terminates before he is eligible for early retirement and dies before his benefit payments begin, a survivor annuity need not be paid to his surviving spouse. 8 However, if such participant terminates before he is eligible for early retirement but has begun to receive benefit payments at the time of his death and after the date on which he would have been eligible for early retirement, a survivor annuity must be payable to his surviving spouse unless the participant elects to the contrary. 9

5 Nonforfeitable means a right to an accrued benefit which at the time of determination and thereafter is an unconditional right. Conversely, with certain exceptions listed in Treas. Reg. § 1.411(a)-4(b)(1977), a right which at the time of determination is conditioned under the plan upon a subsequent event, subsequent performance, or subsequent forbearance which could cause the loss of such right is forfeitable. Treas. Reg. § 1.411(a)-4(a)(1977). For a general discussion of the concept of vesting and when qualified plans traditionally have provided it and when they must provide it under ERISA, see Lee, Credited Service After ERISA, 31 Tax. L. Rev. 367, 375-76 (1976).

Compare I.R.C. § 414(j) with I.R.C. § 414(i), which indicate that the principal characteristic of a defined benefit plan is the absence of individual accounts for the plan participants. Generally, a defined benefit plan specifies that fixed benefits are to be payable at retirement and that contributions to fund such fixed benefits are to be determined actuarially and are to be payable irrespective of profits. See also Treas. Reg. § 1.401-1(b)(1)(i)(1976).

7 I.R.C. § 401(a)(14).


9 Treas. Reg. § 1.401(a)-11(a)(1)(i)(A),(C),(D)(1977). It is assumed that the plan does not provide for early retirement before age 55. If the plan does provide for early retirement benefits to commence before the first day of the 120th month beginning before the partici-
Many defined benefit plans in which the present actuarial equivalent of the participant’s nonforfeitable accrued benefit is less than some standard amount (i.e. $1,750) prefer to pay out or "cash-out" such actuarial equivalent in order to avoid keeping track of terminated participants for payment of their minimal vested accrued benefits at normal retirement age. In a defined benefit plan, once a participant has achieved any degree of vesting by the time of separation he generally cannot incur a forfeiture of his accrued benefit. Consequently, special rules are provided whereby a participant’s accrued benefit can be forfeited upon a cash-out, but his years of service for vesting are not lost.

To forfeit a participant’s nonvested accrued benefit upon a separation from service, where he has attained any degree of vesting at such separation, a defined benefit pension plan must precisely follow the new ERISA cash-out and buy-back rules. There are two types of cash-outs: voluntary and involuntary. In the case of an involuntary cash-out, a forfeiture of a nonvested accrued benefit occurs only if the cash-out: (a) is less than $1,750; (b) consists of the present value of the participant’s entire vested.
benefit at the time of distribution; (c) is paid "on account of"\(^{13}\) the participant's termination of participation in the plan; and (d) if the plan provides for a buy-back or restoration of the forfeited accrued benefit upon certain conditions.\(^{14}\) The rules for a voluntary cash-out are substantially the same except that there is no $1,750 ceiling, the distribution may be less than the present value of the participant's vested benefit at the time of distribution, and the participant's consent must be obtained.\(^{15}\) Only part of a terminated participant's forfeitable accrued benefit may be forfeited where less than one hundred percent of his nonforfeitable accrued benefit is voluntarily cashed out.\(^{16}\) The buy-back rules state that if a distribution of less than the participant's entire accrued benefit (forfeitable and nonforfeitable) is distributed to him in a cash-out after section 411 applied to the plan, he must be permitted upon reemployment to repay the cash-out (plus five percent interest, if required) and thereby restore his previously forfeited accrued benefit.\(^{17}\) A defined benefit plan may require that the buy-back be paid within the earlier of two years after "covered" reemployment or five years after the cash-out.\(^{18}\)

A defined benefit plan may make: (a) involuntary distributions upon a participant's separation from service in excess of $1,750; and (b) distributions without allowing a buy-back. In

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\(^{13}\) Treas. Reg. § 1.411(a)-7(d)(4)(i)(1977) provides that a distribution made within two plan years following the plan year in which the termination occurs is deemed to be on account of termination of participation.


\(^{16}\) Treas. Reg. § 1.411(a)-7(d)(4)(iii)(1977). Specifically, this regulation provides as follows:

> In the case of a voluntary distribution described in subdivision (ii) of this subparagraph which is less than the present value of the employee's total nonforfeitable benefit immediately prior to the distribution, the accrued benefit not required to be taken into account is such total accrued benefit multiplied by a fraction, the numerator of which is the amount of the distribution and the denominator of which is the present value of his total nonforfeitable benefit immediately prior to such distribution. For example, A who is 50 percent vested in an account balance of $1,000 receives a voluntary distribution of $250. The accrued benefit which can be disregarded equals $1,000 times $250/$500, or $500. However, such service may not by reason of this paragraph be disregarded for purposes of determining an employee's years of service under sections 410(a)(3) and 411(a)(4).

\(^{17}\) Treas. Reg. § 1.411(a)-7(d)(4)(iv)(A)(1977). No buy-back is required if the participant is fully vested and if he receives a cash-out equal to the present value of his entire accrued benefit.

such cases however, the plan may not forfeit the nonvested accrued benefit of the participant at the time of the distribution. This does not mean, however, that the plan is forced to make a double payment of the vested accrued benefit previously distributed. The plan is permitted instead to offset the accrued normal retirement benefit that was previously distributed.19

B. Defined Contribution Plans (Non-Class Year)

When a defined contribution plan participant is terminated several complex rules come into play. Of course, the participant’s vested account balance (the analogue of accrued benefit in a defined benefit plan)20 may be distributed to him.21 However, the nonvested or forfeitable account balance generally cannot be forfeited until a one-year break in service occurs.22 But some plan administrators may wish to close out the account prior to a one-year break in service.30

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19 Treas. Reg. § 1.411(a)-7(d)(6)(i)(1977); T.I.R. 1403, Q&A #V-16. The difference between a cash-out and a forfeiture may be illustrated by the following example:

ABC defined benefit plan provides for a benefit of 30% of final average pay, reduced proportionately for years of service less than 25. Employee A terminated employment with five years of service at a time when his “final average pay” was $10,000 and his vested accrued benefit was 25% x 20% (accrued benefit) x 30% x $10,000, or $150 per year. He is paid the actuarial equivalent of this vested accrued benefit upon his separation from service and subsequently returns to employment but is not permitted to repay it. At normal retirement age he has 25 years of participation counting the five years as to which he received a cash-out and his final average pay is $20,000. Accordingly, his retirement benefit will be 100% (accrued benefit) x 30% x $20,000, or $6,000. This amount is then to be reduced by $150 for the prior cash-out, thus leaving $5,850. Had the cash-out, buy-back rules applied, his normal retirement benefit would have been 80% x 30% x $20,000, or $4,800.

Of course, in a career average plan, this result is not obtained, and in such circumstances plan designers may desire not to provide for cash-outs and buy-backs. Even in final average pay plans, it may be desirable from an administrative point of view not to permit buy-backs, but simply provide for cash-outs of the actuarial equivalent up to a certain amount. Note that if a participant is fully vested the buy-back rule does not apply. See note 17 supra. Also it does not apply as to pre-ERISA distributions.


year break in service. In this event the cash-out, buy-back and add-back rules, discussed below, come into play.

Typically, in a defined contribution plan, other than a money purchase pension plan, forfeiture losses are reallocated to the accounts of remaining participants. Consequently, in the first stages under ERISA, many draftsmen simply provided that no distributions would be made to terminated participants in defined contribution plans until they incurred a one-year break in service. The twelve month period against which a one-year break in service is measured for this purpose must coincide with the vesting computation period under the basic hours of service method, so that a one-year break in service could occur as late as twenty-one months after a participant separated from service.

**EXAMPLE:** The vesting computation period under DEF Company's defined contribution plan is based upon the plan year, which is a calendar year. Employee B works some overtime, completing 501 hours by April 1, 1976, and terminates service on that day. Consequently, he will not incur a one-year break in service until December 31, 1977. Of course, by some time in October, 1977, it should be obvious that absent considerable overtime he would not be able to work more than 501 hours in the 1977 plan year, so that practically, perhaps, he incurs a one-year break in service eighteen months after he terminates from service.

However, if the "elapsed time" method is used, a one-year break in service will never occur later than twelve months after the employee severs from service. Whether the distribution is

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23 See Treas. Reg. § 1.401-7(1963). A money purchase pension plan is a pension plan within the meaning of Treas. Reg. § 1.401-1(b)(1)(ii)(1976). Therefore, contributions are payable without regard to profits. However, unlike a defined benefit plan, an individual account is maintained for each participant in a money purchase pension plan, and employer contributions and earnings and losses are allocated to such account.

24 Such allocation must not be in a manner which will effect discrimination in favor of a prohibited group. Treas. Reg. § 1.401-4(a)(2)(ii)(1963). Rev. Rul. 71-4, 1971-1 C.B. 120, indicates that allocation of forfeitures may result in proscribed discrimination, especially, if the members of one of the prohibited groups defined in I.R.C. § 401(a)(4) (i.e., officers, shareholders, or highly compensated employees) have greater service with the employer on the average than the rank-and-file employees. Therefore it is advisable for forfeitures to be allocated on the basis of compensation or any other method which does not take into account longevity of service since prohibited group members generally do work for an employer longer than rank-and-file employees.


26 D.O.L. Reg. § 2530.200b-9(d)(4). For these purposes, an employee is regarded as severing from service on the date on which he quits, is discharged, retires, or dies or the first anniversary of the date on which he is initially absent for any other reason such as layoff or leave of absence. See D.O.L. Reg. § 2530.200b-9(a)(3)(iii).
delayed twelve months, eighteen months or twenty-one months, many plan administrators find delayed distributions administratively impractical.

Alternatively, a defined contribution plan may use cash-out and buy-back rules to forfeit the nonvested account balance of a terminated participant as soon as he receives a distribution of his vested account balance (or at least at the first valuation date following the distribution), without waiting for a one-year break in service.\(^\text{27}\) The voluntary and involuntary aspects of the cash-out follow those of a defined benefit plan. The buy-back rules, however, differ somewhat. A defined contribution plan cannot charge interest on the repayment of the cash-out\(^\text{28}\) and must restore upon the buy-back the exact amount of the forfeited account balance, unadjusted upwards or downwards for subsequent gains or losses.\(^\text{29}\) Such a plan also may provide that the buy-back must be made prior to the earlier of: (a) a one year break in service; (b) two years after “covered” reemployment; or (c) five years after the date of distribution (generally applicable only to in-service withdrawals).\(^\text{30}\)

A major difficulty in the application of the cash-out and buy-back rules to defined contribution plans arises in determining the source for restorations of forfeitures. Permissible sources for restoration of forfeitures upon making a buy-back are as follows: (1) income or gain to the plan; (2) forfeitures; and (3) additional employer contributions.\(^\text{31}\) In practical effect, such sources can be used to fund the restoration in both the year of the restoration and the subsequent year, so that forfeitures for two years, and income or gains to the plan for two years, can be used.\(^\text{32}\) Moreover, in a profit-sharing plan, contributions may be made (and presumably deducted) to restore any forfeited benefit under a buy-

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\(^{32}\) Id. The regulations reason that in order for a profit-sharing plan to be qualified the account balances generally must correspond to the assets in the plan so that there cannot be an unfunded account balance. But, an account balance for the purpose of this requirement “will not be deemed to be unfunded” in the case of a restoration of a previous forfeiture under a plan utilizing a cash-out and buy-back provision so long as the assets used in the restoration are in fact in the plan by the end of the plan year following the plan year in which the repayment occurs.
back even though the employer realizes no profits in the year of the contribution.\(^{33}\) It is less clear whether an employer's contributions of amounts necessary to fund the restoration are currently deductible where the basic employer contribution already equals the maximum deductible amount.\(^{34}\) But fortunately restored forfeitures are disregarded in calculating the overall limitation on annual additions to each employee's separate account.\(^{35}\) Plan administrators also may find restoration of a forfeited account balance particularly galling when the trust fund has suffered severe losses after the cash-out. The returning prodigal participant may be better off than the good participant who stayed home.

Suspecting that most defined contribution plans would not want to use the cash-out and buy-back rules, the draftsmen of the final vesting regulations provide two alternate approaches.\(^{36}\) Both alternatives are based upon the technique of splitting forfeitures and distributions. Namely, a distribution can be made to a terminated participant either shortly after his termination as under a pre-ERISA plan, or shortly after the end of the plan year in which he terminates, but the forfeitures will occur only when and if he incurs a one-year break in service.\(^{37}\)

Complexities generally arise only if the terminated participant is reemployed before he incurs a one-year break in service. How will such participant vest (as he completes post-re-employment service) in the remaining part of his account which was not vested at the date of his termination? The minimum vesting regulations provide two alternatives for computing the vested portion of the remaining account balances in such circumstances.\(^{38}\) They call for an add-back and offset approach under

\(^{32}\) Id.

\(^{33}\) See Lee, supra note 5, at 444.

\(^{34}\) See Lee, supra note 5, at 444.


\(^{37}\) Disqualification may arise from inadvertent forfeitures prior to a one-year break in service where the cash-out and buy-back rules are not met simply because the plan administrator is accustomed to forfeiting a participant as soon as he separates from service. Under some recent authorities, disqualification may nevertheless result from inadvertent errors if rank-and-file employees are injured by such errors. See note 208 infra.

\(^{38}\) Under the following circumstances, both of the alternative approaches require some degree of vesting in the account that was not vested at the time of the distribution, but which was not forfeited either when a defined contribution plan makes a distribution as to employees from their accounts attributable to employer contributions at a time when (a) they are less than 100% vested in such accounts and (b) under the plan the employees can increase their percentage of vesting in such accounts after the distribution. Treas. Reg. § 1.411(a)-7(d)(5)(ii)(1977). In such circumstances the plan must provide that the account balance will be computed in a manner that satisfies one of the two alternatives. Treas. Reg. § 1.411(a)-7(d)(5)(ii)(1977).
both of these alternatives. Namely, an amount equal to the prior cash-out or distribution is “added-back” to the remaining account balance, then the present vesting percentage is applied to this hypothetical account balance, and finally the prior distribution is subtracted from or “offset” against the hypothetical vested account balance, resulting in the actual amount vested.39

The two alternatives differ primarily in the manner in which the add-back is computed. Under the first, or “algebraic formula” alternative, the amount which remains forfeitable at the time of the distribution (of the vested portion of the account) is established as a separate account at such time.40 Then in applying the above steps, the add-back and offset both are adjusted upwards (or downwards) to reflect the subsequent growth (or loss) of the separate account.41

**EXAMPLE:** Employee C separates from service with DEF Company in plan year one at a time when he has sixty percent vested in an account balance of $1,000 in the DEF defined contribution plan which uses the basic hours of service method of crediting service. The plan paid him his vested interest of $600, and before he had a one-year break in service he returned to the employment of DEF Company. The plan administrator set up a separate account for the $400 that was not vested and which was left in employee C’s account when he separated from service and took his $600. In plan year two, employee C completed 1,000 hours of service and advanced another ten percent to seventy percent on the plan’s vesting schedule. To figure out employee C’s vested interest in this separate account of $400 at the end of plan year two, the administrator would first add back $600 for the prior distribution. Then he would multiply the sum of C’s separate account and the distribution ($400 + $600 = $1,000) by seventy percent, giving $700 ($1,000 x 70% = $700). Then the administrator would subtract from that $700 figure a $600 offset for the distribution that employee C had already received. This would leave him with $100 vested in that $400 separate account.

In the above paragraph, the add-back was determined as if the separate account had not increased or decreased. It would in fact be adjusted up and down for the trust income and loss

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40 Treas. Reg. § 1.411(a)-7(d)(5)(iii)(A)(1)(1977). An actual and separate account is not required so long as account balances are maintained under a method that has the same effect as the rules under this alternative. Treas. Reg. § 1.411(a)-7(d)(5)(iii)(A)(1977) (flush language).
under an algebraic formula just as if employee C had left the $600 distribution in the plan. For instance, assume that the $400 in the separate account had grown with future trust income and growth in trust assets to $600. The add-back for the prior distribution would be $900, because if the distribution of $600 had stayed in the plan, it too would have grown by fifty percent, or to $900. Then the administrator would have multiplied $1,500 ($600 + $900 = $1,500) by seventy percent. This would have given a vested interest of $1,050, reduced by a $900 offset for the earlier distribution ($1,050 - $900 = $150). This leaves employee C in plan year two with an additional vested interest of $150 in the actual $600 in his separate account. The same kind of rule applies when the $400 in the separate account has decreased in value through trust losses. Then the administrator decreases the offset.

Any new contributions are placed in a separate account to which the current vesting percentage is applied. Continuing the above example, if $100 were contributed to the separate account in plan year two in which employee C advanced to seventy percent of the vesting schedule, his nonforfeitable interest in the separate account for new contributions would be seventy dollars ($100 x 70%). His aggregate vested interest would be $220 ($70 + $150).

Under the second alternative, no separate account is required for the forfeitable account balance at separation and the offset and add-back are not adjusted for subsequent gain or loss of the trust fund.42

**EXAMPLE:** Using the facts of the preceding example, employee C would have in plan year two a single account in the plan of $700 ($100 new contribution added to remaining account balance of $600). To determine employee C’s vested interest in the $700 balance in plan year two, the administrator would first add back $600 for the earlier plan (not $900 to reflect fifty percent growth of old remaining account balance). The administrator then would multiply the sum of employee C’s account and the payment, or $1,300 ($700 + $600 = $1,300), by seventy percent giving the administrator $910 ($1,300 x 70% = $910). Then the administrator would subtract from that $910 figure a $600 offset for the payment that employee C had already received. This would leave him with $310 vested in his $700 account.

The above examples also serve to illustrate the fact that if the trust fund has net income between the date of the prior distri-

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bution and the date as of which the vested interest is being determined, the employee’s vested interest will be greater under the second alternative.

These two alternatives only establish the floor for vesting on a defined contribution where distributions are made to a not fully vested participant prior to a one-year break in service. Consequently, a plan may use a different method so long as the plan meets one of the two permissible methods. A simpler approach, but one which will give the participant a greater vested interest, is not to use any add-back.\(^\text{43}\) Instead, the reemployed participant’s account, which includes the remaining forfeitable account balance and any new allocations, simply is multiplied by the applicable vesting percentage. Using the same facts as the preceding two examples, in plan year two C would have a vested interest of $490 \([70\% \times \$700 (\$600 + \$100)]\).

C. \textit{Side Effects of Defined Contribution Plan Distributions Prior to a One-Year Break in Service}

The first proposed Treasury Regulations provided for lump-sum distribution treatment (which is partial capital gain treatment and partial ten-year favorable forward averaging “separate basket” treatment)\(^\text{44}\) only upon a separation from service and only for distributions of the entire amount in a separated participant’s account.\(^\text{45}\) The proposed regulations recognized some of the problems of distributions, and attendant forfeitures, prior to a one-year break in service. They disregarded forfeitable amounts in the account which are forfeited in a plan year coincident with or

\(^{43}\) See generally Lee, supra note 5, at 450. One argument in support of this provision is that once a reemployed participant serves the minimum number of years of service required for full vesting, the manner in which the vested interest in his account up to this point has been calculated now makes no difference since he is fully vested. Id. at 449.

\(^{44}\) See I.R.C. §§ 402(a)(2); 402(e). That part of the taxable lump-sum distribution which is attributable to years of participation before January 1, 1974, is treated as long-term capital gain. The remainder of the taxable amount is subject to ten year favorable forward averaging. Actually, the statutory “separate basket” approach does not trace contributions to years of participation before January 1, 1974, and to years of participation after December 31, 1973. Instead, a mathematical formula is used; the portion of the taxable lump-sum distribution attributable to pre-1974 years of participation is determined by multiplying the total taxable lump-sum distribution by a fraction, the numerator of which is the pre-1974 years of participation and the denominator of which is the total years of participation. I.R.C. § 402(a)(2). The remainder of the taxable lump-sum distribution is accorded ten year favorable forward averaging treatment. I.R.C. § 402(e). However, it should be noted that the distributee may now elect to have the entire amount subject to ten year favorable forward averaging treatment. I.R.C. § 402(e)(4)(L).

beginning with the participant’s taxable year in which he received the distribution. In a fiscal year plan, this quite adequately handled the problem of a participant who receives a distribution after having completed more than 500 hours in the plan year in which he separates from service and receives concurrently with his separation a distribution of his then vested account balance. However, in a calendar year plan in which the participant completes more than 501 hours, then separates from service, and receives prior to the end of the plan year a distribution of his vested amount, the forfeiture will occur in a plan year which is neither coincident with the taxpayer’s tax year nor begins within his tax year.

**EXAMPLE:** Employee E in DEF defined contribution pension plan, in which the vesting computation period and breaks in service computation period are the calendar year, separates from service on April 1, 1976, having completed 501 hours of service. He receives a distribution of his vested account balance on May 1, 1976. He does not return to service in 1977, and his nonvested account balance is forfeited on December 31, 1977. Under the first proposed regulations on lump-sum distributions, employee E was not entitled to lump-sum distribution treatment. The interesting argument could have been made that, since at the end of the taxpayer's year it could not be determined whether he would obtain favorable lump-sum distribution treatment or ordinary income treatment, the transaction should be held 'open' until it would be determined which treatment he would receive. Then if he returned to service prior to a one-year break in service and contributed back the distribution, it could be argued that since all recognizable transactions occurred within the same taxable year, he is not taxed.

Temporary regulations were filed on May 26, 1977, which recognized that many plans provide that the forfeiture would take place at a later time than the same taxable year in which distribution is made. Importantly, these temporary regulations extended the time that forfeitures may occur and still not be included in the “amount to the credit” of the employee. Thus, in


many cases distributions will be eligible for favorable lump-sum tax treatment even though they would not have qualified for that treatment under the initially proposed regulations. The temporary regulations also took into account the requirement that the distributions qualify as a lump-sum distribution. Namely, the balance to the credit of an employee would not include the amount subject to forfeiture no later than the close of the plan year within which the employee incurs a one-year break in service and, by reason of the break in service, provided that such amount is actually forfeited at or prior to the close of that plan year, and the break in service occurs within twenty-five months after the employee’s separation from service.\(^4\) Under an elapsed-time plan, the one-year break in service may occur within twenty-five months after the employee’s initial absence from service.\(^5\) An employee can assume that the amount subject to forfeiture will be treated as forfeited by the applicable date. However, if the amount is not forfeited by that date, the amount will be taken into account in determining the balance to the credit of the employee.\(^6\) The temporary regulations do not speak to what occurs if the employee has treated the distribution as a lump-sum distribution and taken a favorable tax treatment and then subsequently does not forfeit the amount.\(^7\)

\(^4\) Id. § 11.402(e)(4)(A)-1(a).
\(^5\) See D.O.L. Reg. § 2530.200b-9(d)(4); D.O.L. Reg. § 2530.200b-9(b)(2). Actually Temp. Treas. Reg. § 11.402(e)(4)(A)-1(a)(2)(1977) states that, under an elapsed time plan, the break in service may occur within 25 months of the employee’s “severance from service.” Presumably this 25-month reference is to the period of continuous absence, for D.O.L. Reg. § 2530.200b-9(d)(4) expressly states that a break in service will occur on the first anniversary of the employee’s “severance from service date.” Under D.O.L. Reg. § 2530.200b-9(b)(2), the “severance from service date” is the earlier of (1) the date on which the employee quits, is discharged, retires, or dies or (2) the first anniversary of the initial date of absence for any other reason. In Temp. Treas. Reg. § 11.402(e)(4)(A)-1(a)(2)(1977), the IRS seems to use the terms “separation from service” and “severance from service” interchangeably. However, in contrast to a “severance from service,” D.O.L. Reg. § 2530.200b-9(c)(3)(ii)(A), which relates only to participation, indicates that a “separation from service” occurs on the first day of absence irrespective of the reason for such absence.

\(^7\) The regulations have no authority, absent a mandate in the statute, to require a reopening of the prior years return and recomputation of the taxes. Such a requirement would seem to be in violation of the annual accounting principle unless statutorily provided for. At the same time application of the tax benefit doctrine in its general sense, namely as a correlated adjustment through bringing into income an amount equal to a prior deduction which should not have been allowed due to circumstances which developed other than as originally supposed, fits awkwardly where rather than an actual deduction in the prior year a favorable rate change or favorable averaging device was availed of. See I.R.C. § 111.
D. Class Year Plans

A class year plan is any profit-sharing, stock bonus, or money purchase pension plan which provides for separate nonforfeitalility of employees' rights derived from employer contributions for each plan year. Each year's contributions and subsequent investment adjustments for a particular participant are treated as a separate class or account on the plan's records. When the account for a particular plan year becomes nonforfeitable, it is said to have "matured."

One common form of class year plan combines a long-term program with a short-term program geared to temporary savings. Generally, the short-term account is distributed to participants after a savings "cycle" of a few years with each year's contributions being kept in a separate "class," and the entire accumulation in that class is available for distribution at the end of the cycle when the class matures. Frequently, such plans provide an employee with elections as to whether to draw down the class year contribution and accumulations at the end of the cycle. The drafters of ERISA, in recognition of the unique class year maturity concept of class year plans, provided an alternative means by which such plans satisfy the minimum vesting standards of I.R.C. § 411(a)(2) as to employer-derived accrued benefits by providing that one hundred percent of each employee's right to employer contributions made on his behalf for any plan (class) year are nonforfeitable "not later than the end of the fifth plan year following the plan year for which such contributions were made."

Onto the bare bones of this provision, the regulations correctly have applied the meat of detailed rules governing forfeitures. These provisions bear little or no resemblance to the years of service, breaks in service, and hours of service provisions generally applicable to vesting. Instead, the benefits in all unmatured classes of an employee who separates from service prior to the time that a particular class year has matured, and who is not reemployed in the plan year of separation, may be forfeited.

Class year plans may use special cash-out and buy-back provisions as an alternative to the class year forfeiture rules. In short, a class year plan may provide that upon a distribution of an

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52 Id.
53 See Lee, supra note 5, at 468-72.
employee's vested account balance (i.e., all matured classes) upon a separation from service, accumulations for classes not yet mature would be forfeited. In such event the plan must provide a buy-back provision under which the employee can restore the forfeited unmatured classes if he repays the prior distribution or cash-out before a certain deadline. Typically both the distribution or cash-out and buy-back occur without separation from service. For this purpose, the class year plan is permitted to limit the time of repayment to the earlier of (a) the five-year period beginning on the date of withdrawal or (b) the time that the employee would forfeit his rights under the regular class year plan rules (for instance, if he actually separated from service). Moreover, any plan or class year as to which there has been a withdrawal of contributions and no repayment of such contributions determined as of the last day of the plan year is not required to be counted towards the five years required for maturing and vesting of such class year.

Most class year plans are thrift plans as well, i.e., they provide for employer contributions being dependent upon mandatory employee contributions. Most thrift plans also provide for a forfeiture of employer contributions which were geared to employee contributions when those employee contributions are withdrawn. ERISA permits such forfeitures subject to certain rules, the most important of which requires a restoration of forfeited amounts upon a repayment of the prior in-service withdrawal of employee contributions. A withdrawal of mandatory employee contributions under a class year plan, triggering a forfeiture of geared employer contributions, is treated as a withdrawal of such contributions on a plan-year-by-plan-year basis in succeeding order of time.

However, perhaps the most significant tax rule applicable to in-service withdrawal of mandatory employee contributions with respect to forfeitures of earned employer contributions is that such forfeitures cannot occur after the participant has a nonforfeitable right to at least fifty percent of his accrued benefit derived from an employer contribution. Neither the Code nor the

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58 Id.
59 Id.
60 Id.
regulations set forth the application of this rule to class year plans. Possibly, the comparison is between the dollar value of all matured classes and the dollar value of all unmatured classes. If the alternate approach of basing the fifty percent test on a class-year-by-class-year basis were adopted, forfeiture of geared employer contributions would always occur in a class year plan upon a withdrawal of employee contributions from an unmatured class year; conversely, each matured class year would be one hundred percent vested so that no forfeiture would ever occur. Since class years under this analysis are either zero percent or one hundred percent vested, use of the statutory fifty percent terminology renders the latter interpretation awkward.

E. Pre-ERISA Cash-Outs and Forfeitures

Many pre-ERISA defined benefit and defined contribution plans provided that upon termination prior to complete vesting, a participant immediately forfeited his entire non-vested accrued benefit; and upon subsequent reemployment he was treated as a new employee for purposes of accrual, vesting, and participation. The question arises as to the effect of pre-ERISA forfeitures in such plans upon a reemployed participant’s post-ERISA benefit and years of service for vesting eligibility. Clearly, both a defined contribution and a defined benefit plan which had such provisions prior to ERISA may provide that for purposes of vesting, years of service completed prior to the pre-ERISA forfeiture may be disregarded. Also, for purposes of eligibility to participate, such years of service may not be disregarded merely because they were not taken into account under the plan’s pre-ERISA break in service rules. Moreover, the cash-out and buy-

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44 This is the equivalent of a participant’s nonforfeitable interest in his benefit derived from employer contributions.

45 See Lee, supra note 5, at 470-71.

46 But see H.R. Rep. No. 93-1280, 93d Cong., 2d Sess., 275 (1974), which states “forfeitures . . . would be permitted on a class-year-by-class-year basis, for any year for which the employee withdraws his own mandatory contributions to the plan, if he is less than 50 percent vested with respect to that year.” Id. (emphasis added). Therefore, notwithstanding the awkwardness of the application of the 50% test on a class-year-by-class-year basis, the Conference Report ostensibly supports such a construction, although the regulations are disturbingly silent.

47 See Lee, supra note 5, at 438.


49 See I.R.C. § 410(a)(5)(A), which states that, with certain exceptions, “all years of service with the employer or employers maintaining the plan shall be taken into account” for eligibility purposes. There is no eligibility provision comparable to I.R.C. § 411(a)(4)(F).
back rules are inapplicable to most pre-ERISA distributions, if for no other reason, because virtually no pre-ERISA plan would have contained a repayment provision at the time of distribution which would satisfy the buy-back provisions.\(^7\)

Computation of the accrued benefit under most defined benefit pension plans turns on the number of “years of participation,”\(^7\) a term which incorporates the years of service and break in service rules used for eligibility purposes.\(^7\) Such participation rules contain no exception for service disregarded under the plan’s pre-ERISA break in service rules.\(^7\) In many circumstances, however, such years of service could be disregarded by a defined benefit plan under the eligibility rule of parity.\(^7\) Consequently, on the basis of the express terms of the statute, pre-ERISA forfeitures under a defined benefit plan apparently can remain forfeited as to reemployed participants only if the eligibility rule of parity is available. Of course, the accrued benefit would be reduced by the “actuarial equivalent” of the pre-ERISA distribution.\(^7\)

Fortunately, the Secretary of Labor at least partly appreciated the administrative nightmare that would result from the application of the literal statutory terms. The final minimum standards regulations permit the disregarding of service for benefit accrual services which could be disregarded under the vesting rule of parity.\(^7\) In turn, service prior to a break in service occurring before the effective date of ERISA may be ignored in applying the vesting rule of parity if such service could have been disregarded under the terms of the pre-ERISA plan.\(^7\) However, the vesting rule of parity is not co-extensive with the vesting rule of parity


\(^7\) I.R.C. § 411(b)(1),(3)(A).

\(^7\) The term ‘year of participation’ means a period of service (beginning at the earliest date on which the employee is a participant in the plan and which is included in a period of service required to be taken into account under section 410(a)(5)) as determined under regulations prescribed by the Secretary of Labor which provide for the calculation of such period on any reasonable and consistent basis. I.R.C. § 411(b)(3)(A).

\(^7\) See note 70 supra. See also Lee, supra note 5, at 438.

\(^7\) See I.R.C. § 410(a)(5)(D). Two requirements must be met before the rule of parity will permit the disregarding of service prior to a break in service. First, the participant must have no vested interest in his accrued benefit. Secondly, the break in service must equal or exceed the pre-break service.


\(^7\) D.O.L. Reg. § 2530.204-1(b).

\(^7\) See note 69 supra.
provision permitting pre-ERISA service to be disregarded if the pre-ERISA break in service rules permitted the cancellation of pre-break in service, as illustrated by the following example:

EXAMPLE: Employee M worked for the CRI Company from July 1, 1964 through June 31, 1974. During this entire period, employee M was a participant in the CRI Pension Plan, which required twenty years of continuous service before a participant would be entitled to a deferred vested pension. Effective June 31, 1974, employee M quit but decided to return on July 1, 1978, the first day of the CRI Pension Plan’s Plan Year. Effective June 30, 1987, employee M again quits. Since the Plan, as amended, includes a ten-year “cliff” vesting schedule, employee M has no vested interest. If he does not return to work prior to July 1, 1996, and thus incurs nine consecutive years of break in service, all service completed before July 1, 1987, may be disregarded under the regulations for both vesting and benefit accrual purposes even if he later resumes his employment. However, if employee M works through June 30, 1988, and is thus fully vested after completing ten years of service, the vesting rule of parity will not apply, and there is no express authority in either the statute or the regulations to exclude the ten years of pre-ERISA participation, notwithstanding the pre-ERISA break in service. 78

The term “year of participation” does not apply to defined contribution plans. 79 Rather the accrued benefit is the account balance 80 and forfeitures can occur only under the vesting minimum standard rules, including the cash-out rules. 81 Under such rules, as applicable to defined contribution plans, a pre-ERISA forfeiture (on account of a termination of employment) clearly could remain forfeited after ERISA if the termination stretched

78 Even in the absence of express authority in ERISA and the minimum standards and other regulations, the Internal Revenue Service routinely approves plans which disregard service prior to a break in service antedating ERISA. Admittedly, the participant may pursue a cause of action under Title I of ERISA to reinstate his pre-break service if neither the participation nor the vesting rules of parity apply, but the authors feel that the drafters of ERISA did not intend to have such service reinstated for benefit accrual purposes. It could even be plausibly argued that the tenor of the final minimum standards regulations, if not the express terms, indicate that a reinstatement of pre-break service for benefit accrual purposes is not appropriate.

81 See I.R.C. § 411(a)(6)(C).
into a one-year break in service prior to resumption of service. If no one-year break in service occurred, there is no basis under I.R.C. section 411 for such forfeiture, unless the statutory definition of accrued benefit for purposes of defined contribution plans as the “balance of the employee's account” solves the problem by reflecting the absence in the account of the forfeited amounts.

II. TERMINATION OF EMPLOYMENT: DEFERRAL OF TAXATION

Normally, any distribution in excess of employee contributions to a terminated participant in a qualified plan will result in taxable income to the terminated employee. However, Congress intentionally has provided some methods (and advisors have devised other methods) to defer taxation of this income. The most common method is by the use of rollover and conduit individual retirement arrangements (IRA's). One of the major

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83 See I.R.C. § 411(a)(6)(C). The rule that pre-ERISA years of service may be disregarded, under the plan’s break in service rules then applicable (even though such pre-break service could not be disregarded under the mandatory post-ERISA minimum break in service rules), only affects the number of years of service to be taken into account in determining the nonforfeitable percentage of the participant’s account balance. The rule does not affect the determination in the account balance itself. Similarly, the vesting rule of parity contained in I.R.C. § 411(a)(6)(D) affects only the years of service to be taken into account in determining the nonforfeitable account balance and does not affect the amount of the account balance itself.
85 I.R.C. § 408 provides for individual retirement annuities, which may be in the form of annuity or endowment contracts issued by an insurance company, and individual retirement accounts, which are trustee or custodial arrangements. See I.R.C. § 408(a) and (b). In addition, rollovers to individual retirement bonds within the meaning of I.R.C. § 409 are permitted.

The following excerpt from I.R.S. Publication 590; Tax Information on Individual Retirement Savings Programs (Oct. 1977), is an excellent description of what constitutes an individual retirement account, an individual retirement annuity, and an individual retirement bond. The excerpt also provides guidance as to how to set up one of these tax-deferred savings programs:

An individual retirement account is a trust or custodial account created or organized in the United States for your exclusive benefit or that of your beneficiaries. It must be created by a written governing instrument that meets these requirements:

First, the trustee or custodian must be a bank, Federally insured credit union, savings and loan association, or (under temporary regulations) an applicant eligible to act as trustee or custodian.
Second, except for rollovers, described later, the trustee or custodian will not accept contributions of more than $1,500 in any tax year (if spousal program, see Retirement Savings for Certain Married Individuals).
Third, you will have a nonforfeitable interest in the account.
Fourth, no part of the trust or custodial funds will be invested in life insur-
ance contracts nor may the assets be commingled with other property except in a common trust fund or common investment fund.

Fifth, your entire interest in the trust must be distributed before the end of the tax year in which you reach age 70 1/2. The distribution may be made in a single sum, or you may receive periodic distributions, starting before the end of the tax year in which you reach age 70 1/2, so long as your entire interest in the trust is distributed over any of the following periods:

a) Your life;

b) The lives of you and your spouse;

c) A period certain not extending beyond your life expectancy; or

d) A period certain not extending beyond the life expectancy of you and your spouse.

Sixth, if death occurs before your entire interest is distributed to you, or if distribution has been commenced to your surviving spouse (as provided in (b) or (d)) and your surviving spouse dies before the entire interest is distributed to your spouse, the remaining undistributed interest will, within 5 years after your death or the death of your surviving spouse, be distributed or be applied to purchase an immediate annuity for your beneficiary or your surviving spouse's beneficiary. The terms of this annuity will provide for payments over the life of the beneficiary, or for a term certain not exceeding their life expectancy. Any annuity contract so purchased will be distributed immediately to the beneficiary or beneficiaries. However, no such annuity contract will be required to be purchased if distributions over a term certain began before your death and the term certain is for a period permitted under (c) or (d).

Model trust and model custodial account. The Internal Revenue Service has formulated a model trust and a model custodial account agreement that meet the requirements of an individual retirement account for those individuals who wish to adopt this program. Form 5305, Individual Retirement Trust Account, or Form 5305-A, Individual Retirement Custodial Account, may be used for this purpose. These forms are agreements entered into between the eligible individual and the trustee or custodian. Contributions made under the model trust or model custodial account will be deductible within the prescribed limits if the terms and conditions of the trust or custodial account are followed.

An individual retirement annuity is an annuity or endowment contract issued by a life insurance company in your name as owner and annuitant for your exclusive benefit or that of your beneficiaries. Annuity and endowment contracts must meet the following requirements:

1) Your interest in the contract must be nonforfeitable;

2) The terms of the contract must provide that the contract is not transferable;

3) The annual premium under the contract must not exceed $1,500 (if spousal program, see Retirement Savings for Certain Married Individuals) and any refund of premiums must be applied (before the close of the calendar year following the year of refund) toward the payment of future premiums or toward the purchase of additional benefits;

4) Distributions must be made as discussed earlier under item five, An individual retirement account; and

5) Distributions to beneficiaries after your death or the death of your spouse must be the same as discussed under item six, An individual retirement account.

Endowment contracts. In addition to satisfying the requirements applicable to the individual retirement annuity, an endowment contract must satisfy the requirement of not maturing later than the tax year in which you reach age 70 1/2. Also, if the sum of the annual premiums due under an endowment contract and the aggregate annual premiums due under all other endowment contracts, previously purchased in your name, exceeds $1,500 (if spousal program, see Retirement Savings for Certain Married Individuals) such endowment contract
will not be treated as an individual retirement savings program.

If you purchase an endowment contract, only that portion of the premium that is allocable to retirement savings is deductible. The portion of the premium that pays for current life insurance is not deductible. However, you may contribute the difference between your maximum allowable deduction and the amount allocable to the retirement savings portion of the endowment contract to an individual retirement account, or you may invest the difference in retirement bonds. For example, if you compute your allowable retirement savings deduction for the year to be $1,000, and the premium on your endowment contract is $900 of which $200 is allocable to the life insurance, then you may contribute $300 to a separate individual retirement account. However, if you do not contribute the $300 to a separate account, your deduction will be $700. The insurance company that issued the endowment contract to you will provide you with an annual statement indicating the portion that is allocated to life insurance and is not deductible.

Retirement bonds are a special series of U.S. Individual Retirement Bonds issued by the Federal Government under the provisions of the Second Liberty Bond Act as amended. Rather than establishing an individual retirement account or annuity, you may purchase these bonds and deduct the cost. The bonds provide the following:
1) Interest is paid only upon redemption;
2) Interest is not payable if the bond is redeemed within 12 months after the issue date;
3) Interest is not paid after the earlier of the date that the registered owner reaches age 70 1/2 or 5 years after the date on which the registered owner dies, but not later than the date on which the decedent would have reached age 70 1/2 had death not occurred;
4) Except in the case of a rollover contribution, purchases are limited to the lesser of $1,500 or 15% of compensation per tax year (if spousal program, see Retirement Savings for Certain Married Individuals);
5) Transfers of bonds are generally not permitted; and
6) Selling, discounting, or pledging of the bonds as collateral for a loan or as security for the performance of an obligation is not permitted.

These bonds are issued at par value in varying denominations and bear interest at the rate of 6% compounded semiannually. They may be redeemed with interest at any time after the first 12 months from the issue date. However, if they are redeemed before the registered owner reaches age 59 1/2, becomes disabled, or dies, there is a penalty tax equal to 10% of the amount redeemed in addition to the normal amount of tax resulting from the inclusion of the value of the bond(s) in gross income.

No written agreement is necessary if you purchase U.S. Individual Retirement Bonds for your individual retirement savings program. The bonds will be issued in your name as the registered owner, and you may designate a beneficiary.

Individual retirement bonds may be purchased over the counter or by mail from Federal Reserve Banks and Branches and the Bureau of Public Debt, Securities Transactions Branch, Washington, D.C. 20226. Applications for the purchase of individual retirement bonds should be made on Form PD 4345, accompanied by a remittance to cover the purchase price. Personal checks will be accepted, subject to collection. Checks, or other forms of exchange, should be drawn to a Federal Reserve bank or the Department of the Treasury, as the case may be. Checks payable by endorsement are not acceptable.

Id.
themes in the pension reform legislation culminating in ERISA was portability so that an employee could carry his vested accrued benefit with him when he changed employers. Many alternatives were proposed, but only the rollover provisions were enacted. A rollover is a transfer of a sum of money representing an employee's vested rights from one qualified plan to another qualified plan or to an IRA. Rollovers are also permitted between different types of IRA's and from an IRA to a qualified plan. In the case of a qualifying rollover, the recipient of the distribution from the qualified plan (or IRA) is not taxed upon such receipt provided that not later than the sixtieth day after the day on which the recipient receives the distribution the amounts distributed are contributed to an IRA or another qualified plan. Distri-

butions from a qualified plan must meet one of two prerequisites to qualify for rollover treatment: either the distribution must constitute a lump-sum distribution, or the distribution must consist of the balance of a participant's interest and must be on account of a plan termination (or in some circumstances a partial plan termination).

Unfortunately, the IRA approach is not without its disadvantages. This portion of the Article discusses rollovers and conduit IRA's, their drawbacks, and some alternatives to their use.

A. General Requirements for Rollover and Conduit IRA's

Rollovers between IRA's are permitted in order to enable an individual to shift his investments, for example, from, or to, an annuity contract, a mutual fund or a savings account. But to prevent too much shifting of investments an individual can only transfer amounts between IRA's once every three years. How-

otherwise

\footnote{I.R.C. §§ 402(a)(5), 403(a)(4).}

\footnote{I.R.C. § 408(d)(3). A distribution from an IRA may be transferred to a qualified plan (in contrast with a transfer to another IRA) only if no contributions have been made to the IRA except qualifying distributions from a qualified plan. I.R.C. § 408(d)(3)(A)(ii).}

\footnote{I.R.C. §§ 402(a)(5)(B), 403(a)(4)(B), 408(d)(3)(A).}

\footnote{I.R.C. §§ 402(a)(5)(A), 403(a)(4)(A). Whether a partial termination of the plan occurs will depend upon the facts and circumstances. Treas. Reg. § 1.411(d)-2(b)(1977). One fact that may indicate a partial termination is a substantial reduction in an employer's work force and thus in the number of plan participants. As a guideline, a greater than 20% reduction in the number of participants during the plan year, or a greater than 25% reduction in the number of participants during two consecutive plan years, raises at least the specter of a partial termination. However, only certain partial terminations resulting from the sale of a subsidiary or assets expressly qualify for rollover treatment. See I.R.C. §§ 402(a)(5)(A)(i), 402(a)(6)(B), 403(a)(4)(A)(i), 403(a)(5)(B).}

\footnote{I.R.C. § 408(d)(3)(B).}
ever, an individual may rollover qualifying distributions from a qualified plan to an IRA within that three-year period. The conference approach was to combine elements of the House and Senate bills. There is no central portability fund, but certain qualifying distributions from qualified plans may be received on a tax-free basis if they are reinvested by the participant within sixty days in an IRA or transferred to another qualified plan either directly or through the medium of “conduit” IRA.

The technical requirements for a tax-free rollover of a qualifying lump-sum distribution are as follows: (1) only an employee may make a tax free rollover, but a beneficiary of a deceased employee may not do so; (2) a distribution from a qualified plan which is contributed to a “qualified” IRA not later than sixty days after its receipt is not included in the distributee’s gross income in the year in which it is paid or distributed to him, if the distribution constitutes the balance to the employee’s credit and is paid to him (within one of his taxable years) in one or more distributions constituting a lump-sum distribution, as defined in section 402(e)(4)(A), but without reference to the post-age fifty-nine and one-half one-shot election rule. By incorporating the lump-sum distribution definition of section 402(e)(4)(A), the rollover IRA provisions inherited the pre-ERISA frequently litigated controversy as to what constitutes the “separation from service” of a participant other than a self-employed individual. Particu-
larly harsh in this context was the received principle that a distribution to an employee who separated contemporaneous with a termination of the plan, but who received distribution on account of the plan termination, and not on account of his separation, did not qualify for lump-sum distribution treatment.\textsuperscript{97} This problem has been solved in most, but possibly not all, instances through post-ERISA legislation which extended rollover IRA treatment to most plan terminations.\textsuperscript{98}

A second, and even more common problem, arose from the requirement that the distribution constitute the “balance to the credit” of a participant. Since a forfeiture can occur up to twenty-one months after a participant separates from service under the basic method of counting hours of service or up to twenty-four months in some circumstances under the elapsed time method,\textsuperscript{99} an uncertainty can exist for some time after a distribution of the vested portion of a terminated participant’s accrued benefit as to whether such distribution constitutes the balance to his credit. At the same time, as discussed below, the rollover must occur within sixty days after the distribution. Accordingly, a recipient is likely to rollover a distribution long before amounts subject to forfeiture are actually forfeited.\textsuperscript{100} To resolve this quandry, the temporary regulations provide that the participant may assume that a distribution is a lump-sum distribution even though part of the balance of his account has not been forfeited at the time the distribution is made, and he may roll the distribution over to an IRA.\textsuperscript{101}

Should it subsequently and retroactively not qualify because the amount subject to forfeiture was not in fact forfeited within twenty-five months after the participant’s separation from service, the rollover contribution is treated under the temporary regulations as an excess contribution\textsuperscript{102} to the IRA, deemed made in

I.R.C. § 402(e)(4)(A). Because only an employee may make a rollover, a distribution upon the death of an employee may not be rolled over by his beneficiary. I.R.C. §§ 402(a)(5), 403(a)(4).


\textsuperscript{98} See text on 4, note 53 & accompanying text infra.


\textsuperscript{101} “Excess contributions” are defined in I.R.C. § 4973(b) as the excess of IRA contributions for the given year over the amount of a qualifying rollover plus any amounts
the first taxable year of the employee in which it can be determined that an amount subject to forfeiture will not in fact be forfeited, rather than in the taxable year of the actual contribution.103 Unfortunately, such an excess contribution triggers a non-deductible excise tax equal to six percent of the excess.104 This six percent excise tax continues until the excess contribution is flushed out of an IRA or can be applied to cover a savings IRA deduction under section 219 or section 220.

The temporary regulations simply do not speak to the question of the income tax consequences of the rolled over amount retroactively not constituting a lump-sum distribution. Since the rolled over amount is not to be treated as a lump-sum distribution, it will be taxed as ordinary income and will not be subject to favorable separate basket ordinary income ten-year forward averaging treatment or capital gains treatment. The year of inclusion is unclear. In fact, it may be one of three years: the year of the attempted rollover, the year in which it is determined that the forfeiture does not occur,105 or even the year of ultimate distribution from the IRA.106

Moreover, if the hapless recipient then withdraws the “erroneous” rollover contribution from the IRA, prior to attaining age fifty-nine and one-half, he is subject to still another non-

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104 I.R.C. § 4973(a). See also I.R.C. § 408(d)(4), which may provide some relief. However, the flush language added to I.R.C. § 4973(b) by section 1501(b)(8) of the Tax Reform Act of 1976 limits relief to cases where the excess contribution (i.e., the disqualified rollover) does not exceed $1,500 or $1,750.
105 Inclusion in the year in which it is determined that the forfeiture does not occur is based on an analogy to the tax benefit doctrine. See I.R.C. § 111; Treas. Reg. § 1.111-1(a)(1960). Namely, when a transaction is closed and the taxpayer takes a deduction in year one, he must restore a corresponding amount to income in the subsequent year in which it is discovered that the factual assumptions upon which the year was closed were erroneous and affect the character or amount of the deduction. However, such a correlative adjustment does not have to be made where the original deduction did not give rise to a tax benefit. Compare Alice Phelan Sullivan Corp. v. United States, 381 F.2d 399 (Cl. Ct. 1967), with Streckfus Steamers, Inc., 19 T.C. 1 (1952), and Adolph B. Canelo, 53 T.C. 217 (1969), aff'd, 447 F.2d 484 (9th Cir. 1971). A second analogy, the option situation, indicates that the proper year of inclusion may be the year in which it is determined that the forfeiture does not occur; the transaction is to remain open until the nature and character of the transaction can be determined. See note 50 supra.
106 See I.R.C. § 408(d)(1). However, this provision may even result in double inclusion in income instead of deferring a single inclusion in income. See Richard W. Orzechowski, 69 T.C. No. 62 (Feb. 22, 1978).
deductible excise tax on a premature distribution from an IRA.⁴⁰⁷ The amount of this excess tax on a premature distribution is ten percent of the amount of the withdrawal.⁴⁰⁸

There seems to be no sound policy reason for imposing either the excess contribution or the premature distribution excise tax where the temporary regulations expressly authorize a rollover prior to the time that it can be determined whether a forfeiture will occur. Such a result seems unduly burdensome. Hopefully the final regulations will adopt a "wait-and-see" attitude. If the amounts subject to forfeiture at the time of the rollover are not subsequently forfeited, the IRA balance as of the close of the year in which the nonforfeiture is determined should be includible in income for income tax purposes, such amount should not be regarded as an excess contribution, and the ensuing distribution from the IRA should not be treated as a premature distribution.⁴¹⁰

Because section 402(a)(5)(A)(ii) specifically states that the separate basket averaging election rule does not apply to a rollover IRA contribution, but does not similarly make inapplicable the five years of participation requirement for a lump-sum distribution, the five years of participation requirement is apparently a prerequisite for rollover IRA treatment,⁴¹⁶ but Congress agrees that there is no sound policy reason for a five years of participation prerequisite to rollover IRA treatment.⁴¹¹

B. Rollover to IRA

The distributee must transfer all of the property which he receives in the lump-sum distribution to an IRA, either an individual retirement accountn ⁴¹² or an individual retirement annuity¹¹³ (other than an endowment contract),¹¹⁴ or to a retirement

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¹⁰⁷ I.R.C. § 408(f).
¹⁰⁸ Id.
¹⁰⁹ Again, a conceptual basis for such a "wait-and-see" approach could be the option cases. See note 50 supra. But see Richard W. Orzechowski, 69 T.C. No. 62 (Feb. 22, 1978).
¹¹² Apparently, a rollover may be made to more than one individual retirement account. See Ltr. Rul. 7,723,024 (1977), which actually involves individual retirement annuities. However, the disjunctive phraseology of I.R.C. § 402(a)(5)(i) and 403(a)(4)(B)(i) seemingly does not permit a rollover in part to an individual retirement account and in part to an individual retirement annuity, although it is possible that the same result can be achieved by initially rolling over the lump-sum distribution to an individual retirement account and then rolling over part of this account into an annuity under I.R.C. § 408(d)(2).
¹¹³ See Ltr. Rul. 7,723,024 (1977), which permits a rollover to multiple individual retirement annuities. Again, however, I.R.C. § 402(a)(5)(B)(i) and 403(a)(4)(B)(i) ostensi-
bond, on or before the sixtieth day after the date he receives the property, to the extent that it exceeds the fair market value of the amounts considered contributed by him to the plan (reduced by amounts previously distributed to him and not includible in gross income). The amount transferred to the rollover IRA must consist of cash equal in amount to the cash distributed plus the *same* property other than money received in the distribution, excluding the employee's contributions. Thus, in a noncontributory plan the full amount of the distribution must be rolled over, but no income realized with respect to the distributed property during the period of up to sixty days between the date of the distribution and the date of the rollover contribution can be rolled over. On the other hand, in a contributory plan, the employee must exercise extreme caution to avoid rolling over any part of his prior contributions to the plan. This problem can arise as well in a noncontributory plan where the employee had life insurance protection while a participant and was taxed on the value of the term insurance costs. Care must be taken to hold out an amount equal apparently to the aggregate P.S. 58 costs on which the employee has been taxed. Other serious problems exist in a lump-sum distribution plan which includes, in part, life insurance. An endowment contract is the only type of IRA which can have life insurance features. The exclusion of an endowment contract from an acceptable receptacle for a rollover IRA, therefore, means that a life insurance policy distributed to the employee cannot be rolled by him into an IRA. At the same time he must roll all property distributed in kind. Accordingly, distribution of a life insurance policy could conceivably preclude use of an IRA rollover. One solution would be for the plan to surrender the

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116 Id.
118 Id. Since I.R.C. § 72(f) and Treas. Reg. § 1.72-8 (1964) limit the sum treated as employee contributions to the amounts includible in the employee's gross income, earnings and losses attributable to the employee's contributions apparently may not be taken into account in reducing or increasing the amount of the rollover.
119 See Treas. Reg. § 1.72-8 (1964) and Treas. Reg. § 1.72-16 (1963), which hold that the P.S. 58 cost of life insurance protection for an employee is includible in the gross income of the employee when paid and is, therefore, treated as an employee contribution to the extent of such P.S. 58 cost.
120 See I.R.C. § 408(a)(3).
Alternatively, if continuing insurance coverage is sought, the participant may buy the policy from the trustee for its cash surrender value prior to the lump-sum distribution. As a second alternative, the plan may borrow the full cash surrender value and then distribute both the loan proceeds and the stripped policy to the participant. The participant may then retain the stripped policy and roll the loan proceeds over to an IRA.

An employee might receive a distribution because he separated from service which is described as his nonforfeitable account balance. In a subsequent year he might receive a second distribution from the plan administrator because a mistake was made in the computation of the balance to his account. Such a subsequent distribution, if accidental, would not knock the initial distribution out of lump-sum distribution status for purposes of the capital gains provisions applicable to certain lump-sum distributions or the separate basket ten-year forward averaging device. Not surprisingly, therefore, the Internal Revenue Service has ruled that in such circumstances, the initial rollover contribution is not taxable to the recipient (and presumably is not treated as an excess contribution either), but the second distribution may not be rolled over and must be reported as ordinary income in the year of receipt.

Distributions from an IRA generally are included in gross income to the full extent of the distribution — the employee is treated as having a zero basis in the account — and there is no special tax treatment for lump-sum distributions from an IRA, such as capital gains on the pre-1974 contributions, the ten-year...
separate basket averaging device as to post-1973 contributions, or the exclusion from income of unrealized appreciation in employer securities. Accordingly, wherever significant tax advantages would be possible under any of those rules, a rollover IRA should be carefully examined since those advantages are lost. As discussed below, some, but not all, of such advantages may be reacquired through a second rollover from the IRA to a qualified plan.

C. Rollover to Qualified Plan Trust

Code section 402(a)(5)(B)(ii) provides for rollovers between qualified plans without any intervening IRA (but with a distribution to the employee), provided that all the tests applicable to a rollover to an IRA are met: (1) the employee is the distributee; (2) the distribution is either a lump-sum distribution or a distribution of the participant’s entire interest in the plan upon the termination of the plan; (3) the amount transferred to the second qualified plan consists of the property (other than money) distributed, to the extent the fair market value of such property does not exceed any employee contributions; and (4) such rollover to the qualified plan must be made on or before the sixtieth day after the date of distribution from the first qualified plan. In addition, the receptacle qualified plan must provide for the acceptance of such rollover contributions, and such a rollover contribution to a qualified plan is not available if any part of the rollover contribution was attributable to an H.R. 10 plan under which the recipient of the distribution was ever a self-employed individual at the time contributions were made on his behalf under the plan, in order to preclude a self-employed individual from avoiding the various limitations upon distributions from an H.R. 10 plan.

Any plan provision accepting a rollover must be administered in a nondiscriminatory fashion within the meaning of section 401(a)(4), and the employee must be an employee of the employer maintaining the receptacle plan before such a contribu-

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tion could be accepted by the trust. Thus, if the employee is not immediately reemployed, he would be advised to delay receiving the distribution from the first plan or the conduit IRA until he commences his employment with the employer maintaining the second plan. In such circumstances, care must be taken to avoid constructive receipt, for amounts constructively received or "made available" under the first plan would be treated as employee contributions and would not be available for rolling over into a qualified plan unless the rollover is completed within sixty days of the date on which they were initially constructively received or "made available". The consequences of a disqualifying rollover into a second qualified plan may be disastrous to all concerned.

Rollovers are permitted from an IRA to a qualified plan if no amount in the account, or not part of the value of IRA annuity or bond, "is attributable" to any source other than rollover contributions from a qualified plan and the earnings thereon. Addition­ally, the total distribution from such "conduit" IRA must be contributed to the qualified plan within sixty days after its receipt. Therefore, if it is contemplated that the rollover IRA

131 Otherwise, the second plan would fail to meet the exclusive benefit requirement of I.R.C. § 401(a).

132 Constructive receipt occurs when an obligor is willing and able to pay an ascertainable sum to which the taxpayer is entitled but the taxpayer turns his back on the payment for no valid purpose other than the deferral of the tax consequences. The doctrine of constructive receipt, or its statutory analogue "made available" under I.R.C. § 402(a)(1), may be less of a danger with IRA, since I.R.C. § 408 speaks only to payment. See Ltr. Rul. 7,816,063 (1978). At the same time in theory, although quite possibly not in IRS practice, the doctrine of constructive receipt would appear to apply even where there is no statutory trigger as in I.R.C. § 402.

133 See Treas. Reg. § 1.451-2(a) (1971). Presumably a disqualifying rollover would be treated as a voluntary contribution. The Service has long administratively taken the position that voluntary contributions in excess of 10% of compensation may not be made to a qualified plan. Rev. Rul. 70-658, 1970-2 C.B. 86; Rev. Rul. 59-185, 1959-1 C.B. 86. However, the 10% benchmark takes cognizance of past underutilization of the voluntary contribution mechanisms of the plan; if no voluntary contribution had been made, a participant may make a voluntary contribution equal to 10% of his aggregate compensation for all years of participation in the plan. Rev. Rul. 69-217, 1969-1 C.B. 115. Once even this liberal ceiling is exceeded, the Service has taken the position that the plan would be disqualified, presumably as to all participants and not just the over-contributor. See Rev. Rul. 72-349, 1972-2 C.B. 219; Rev. Rul. 69-627, 1969-2 C.B. 92. Also, the implication under I.R.C. § 415 of a disqualifying rollover contribution must be taken into account. Namely, half of the so-called voluntary contribution would be subtracted from the permissible employer contributions and allocations of forfeitures under defined contribution plans. See I.R.C. § 415(c)(2)(B).


might ever be used as a "conduit" for a later roll into a qualified plan, the rollover IRA should never have any direct savings IRA contributions. Rather a separate "savings" IRA should be used for any new contribution.\textsuperscript{136} It is unclear whether, if a rollover IRA has had additional nonrollover contributions, it can be cleansed by rolling the nonrollover contributions and associated earnings into another IRA.\textsuperscript{137} Similarly, it is unclear whether a rollover IRA may be partially rolled into another IRA under an IRA-to-IRA roll, with the remainder of the original rollover contribution being rolled from the original IRA to another qualified plan.\textsuperscript{138} Just as in a roll without an intervening IRA to a participant and then to a qualified plan, the qualified plan must provide for accepting the rollover; and such provision must be administered in a nondiscriminatory manner.\textsuperscript{139}

The basic reason for a rollover to a qualified plan from an IRA or for a rollover to a qualified plan without an intervening IRA is to obtain the income tax advantages of a lump-sum distribution from a qualified plan,\textsuperscript{140} or conversely, the residual estate and gift tax advantages of a non-lump-sum distribution from a qualified plan\textsuperscript{141} over a three year annuity payout from an IRA.

One major difference between a rollover to a qualified plan trust and a rollover to an IRA is that, subject to the incidental death benefits test as to continued premiums, a life insurance policy on the employee's life held in the old qualified plan can be rolled into an employees' trust, provided that it permits a partici-
pant to earmark investments as to insurance contracts. Conceivably, however, there may be residual discrimination in operation problems.142

In a significant number of cases employers have terminated plans and distributed their assets even though the employees continued to work for the same employers, e.g., when an employer’s stock or assets are acquired by another corporation, and the employer becomes a subsidiary or division of the other corporation or when the employer simply terminates the plan, for example, due to the complexities of ERISA.143 The amounts distributed to an employee in these circumstances do not meet the separation from service aspect of the lump-sum distribution test for tax-free rollovers.144 Congress believed that this result was particularly unfair because, in many cases, the employee who received the distribution and who had to pay the tax on it neither requested nor wanted the distribution to be made.145 Congress recognized the fact that since ERISA was enacted approximately 1,600 pension plans had been terminated by companies. Other estimates were that there were 5,600 terminated plans in 1975 affecting about 158,000 individuals.146

Accordingly, Congress enacted H.R. No. 12,725147 in 1976, which was intended to make tax-free rollover treatment available to a distribution despite the fact that it is made on account of the termination of the plan or complete discontinuance of the contributions under the plan; and rollover treatment is also made available in certain situations involving sales of subsidiaries and divisions of corporations.148

142 Simmons, 33 N.Y.U. INST. ON FED. TAX. 507 (1975).
143 See H.R. REP. No. 94-1020, 94th Cong., 2d Sess. 3 (1976).
144 See note 96 & accompanying text supra.
145 122 CONG. REC. H3302 (1976).
146 Id. at H3303; 122 CONG. REC. S5719 (1976).
147 Pub. Law No. 94-267.

[The provisions] would allow distributions that resulted from plan terminations or from complete discontinuance of contributions to be rolled over tax free into another qualified plan as long as the distribution consisted of the balance to the credit of an employee and is paid within one taxable year. Also, for the purpose of this [provision] . . . , if an employee of a subsidiary corporation or a corporation which is a member of a controlled group of corporations receives a distribution from the plan of the parent corporation or another member of the controlled group in connection with the liquidation, sale or other means of terminating the parent-subsidiary or controlled group relationship, the distribution can be treated as if it were made on account of the termination of the plan, and could be eligible for tax-free roll-over treatment. Similarly, if a
Technically, the plan termination rollover provisions (both to IRA’s, and to a qualified plan trust) are largely identical to a lump-sum distribution rollover provision, except that instead of qualifying as a lump-sum distribution, the balance to the credit of the employee must be paid to him, within one of his taxable years, on account of a termination of the plan or, in the case of a profit-sharing or stock bonus plan, a complete discontinuance of contributions.\(^\text{148}\) The plan termination rollover provisions thus avoided the pre-ERISA difficulty of a recipient’s showing whether a distribution was on account of the employee’s separation from service or on account of termination of the plan, and of whether a separation from service existed where the employee continued to work for the same employer.\(^\text{149}\) A complete discontinuance of contributions in a profit-sharing or a stock bonus plan is deemed to occur on the date the plan administrator notifies the Service.\(^\text{150}\) Because there is no requirement that the distribution qualify as a lump-sum distribution, there is no requirement of five years of participation for use of a plan termination IRA.\(^\text{151}\)

The prior separation from service cases in the context of plan terminations had almost invariably involved clean terminations, i.e., the new beneficial owners terminated the plan.\(^\text{152}\) But there had been considerable discussion in the legislative development of ERISA concerning corporate acquisitions and de-acquisitions where the plan continued to exist, but many employees were...

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\(^\text{151}\) See I.R. 1676 (Oct. 1, 1976); I.R.S. Publication 590 (Oct. 1977). “The tax-free rollover treatment applies without regard to whether the employee has been a participant for 5 or more tax years. . . .” Id. at 4.

\(^\text{152}\) See United States v. Haggart, 410 F.2d 449 (8th Cir. 1969); United States v. Johnson, 331 F.2d 943 (5th Cir. 1964); Victor S. Gittens, 49 T.C. 419 (1968).
forced to leave it and the employer in a gradual plant shut-down, etc. One may expect that in the post-ERISA era, such situations may be treated as a partial termination of the plan with a payment of nonforfeitable funded accrued benefits to the departing employees. In such event one may expect to see distributions to the departing employees. With this scenario in mind, Congress extended the plan termination rollover rules through sections 402(a)(6)(B)(i) and 403(a)(5)(B)(i) to cover situations where the plan continued to exist but many employees had been forced to leave the plan as "when a conglomerate sells off one of its subsidiaries." Also, sections 402(a)(6)(B)(ii) and 403(a)(5)(B)(ii) deal with similar situations where a corporation sells a division or branch which was not formally organized as a subsidiary corporation.

Code sections 402(a)(6)(B)(i) and 402(a)(5)(B)(i) technically treat a payment or distribution to an employee as if it were made on account of termination of the plan where the payment constitutes the balance to the credit of the employee of a (employer) corporation, which is a subsidiary or a member of a controlled group, if such payment is made "in connection with" a liquidation, sale or other means of terminating the parent-subsidiary or controlled group relationship of the employer corporation with the parent corporation or controlled group. The employee of the

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156 Actually, there are two types of controlled groups. See I.R.C. § 1563(a). The most common is the parent-subsidiary controlled group. Although I.R.C. § 1563(a)(1) requires 80% ownership for a subsidiary to be a member of the controlled group, I.R.C. §§ 402(a)(6)(B)(i) and 403(a)(5)(B)(i) reduce this ownership requirement to 50%. The second type of controlled group is the brother-sister controlled group, which has received considerable attention in light of the enactment of I.R.C. § 414(b) and (c), both of which were added by ERISA. A brother-sister controlled group results if five or fewer shareholders own at least 80% of the stock of two or more corporations and if more than 50% of the stock ownership by such shareholders in the corporations represents overlapping interests. See Treas. Reg. § 1.1563-1(a)(3)(1973). Compare T.L. Hunt, Inc. v. Commissioner, 562 F.2d 532 (8th Cir. 1977), rev'd 35 T.C.M. 966 (1976), and Fairfax Auto Parts of N. Va., Inc. v. Commissioner, 548 F.2d 501 (4th Cir. 1977), rev'd 65 T.C. 798 (1976), with Charles Balolian Co., 68 T.C. 620 (1977), all of which address the situation where one person owns all of the stock of one corporation and more than 50% of the stock of a second corporation which has five or fewer shareholders. Again, I.R.C. §§ 402(a)(6)(B)(i), 403(a)(5)(B)(i) reduce the 80% test to a 50% test.

employer corporation cannot, at the time of the distribution, be an active participant in the plan of the parent or of the controlled group from which the distribution is made.\textsuperscript{158} Moreover, the distribution must be made not later than the end of the second calendar year in which the liquidation, sale or other means of terminating the parent-subsidiary or controlled group relationship occurs in order to meet the "in connection with" test.\textsuperscript{159} The clear implication of this provision is that the employee must be an employee of the employer corporation at the time of the termination of the parent-subsidiary or controlled group relationship.\textsuperscript{160}

A separate provision applies where (1) through a sale or transfer a corporation (the acquiring corporation) acquires substantially all of the assets used by the previous employer of the employee (the selling corporation) in connection with a trade or business conducted by the selling corporation, (2) the employee is employed by the acquiring corporation, and (3) the balance to the employee’s credit is paid to him in connection with the sale or the transfer of such assets.\textsuperscript{161} This provision was directed at a sale by one corporation to another corporation of the assets of the former corporation used in a trade or business, usually a branch or division, as a result of which the employees of the seller become employees of the buyer and receive a subsequent distribution from the seller’s plan.\textsuperscript{162} Again, there is a requirement that the payment or distribution be made no later than the end of the second calendar year after the calendar year in which the sale or

\textsuperscript{158} Id.

\textsuperscript{162} H.R. Rep. No. 94-1020, 94th Cong., 2d Sess. 3-4 (1976). In this context the single versus separate business requirement for I.R.C. § 355 has been abandoned by the Service. See generally Lee, Proposed Regulations under § 355 Overhaul Device Test and Single-Business Provisions, 46 J. Tax. 194 (1977). This abandonment may give rise to familiar specter, for the literal language of I.R.C. §§ 402(a)(6)(B)(ii) and 403(a)(5)(B)(ii) may be construed to contemplate acquisition by the acquiring corporation of one of several entire trades or businesses conducted by the selling corporation. Where the pre-split-up corporation has a single trade or business, §§ 402(a)(6)(B)(ii) and 403(a)(5)(B)(ii) may not literally apply. Certainly Congress did not intend this, but the gap may yet remain. See Lee, How to Salvage Tax Benefits When a Professional Organization Disbands, 45 J. Tax. 14 (July, 1976).
transfer of assets occurs.\textsuperscript{163}

The plan termination IRA provisions obviously are intended to be quite broad. However, if a division of a corporation which is not a member of a controlled group immediately prior to a divisive reorganization\textsuperscript{164} is dropped into a newly formed subsidiary and simultaneously spun-off or split-off, or the parent corporation is liquidated simultaneously in a split-up, sections 402(a)(6)(B) and 402(a)(5)(B) and hence sections 402(a)(5)(A)(i) and 403(a)(4)(A)(i) may not apply. When sections 402(a)(6)(B)(i) and 402(a)(5)(B)(i) speak of liquidation, sale, or other means of terminating the parent-subsidiary or controlled group relationship, these provisions appear to contemplate the separation of an existing subsidiary with employees, for they speak of a payment of the balance of the credit of an employee of a corporation which is a subsidiary. In a split-up of the type described, the employee is an employee of the parent and then of the newly split-off corporation; in reality he is never an employee of a subsidiary.\textsuperscript{165} The other leg of this provision, section 402(a)(6)(B)(ii), speaks of an individual who is an employee of the corporation which then sells or otherwise transfers substantially all the assets used in a trade or business conducted by it to an acquiring corporation. This provision can only awkwardly be molded into a divisive reorganization involving the split-off of a segment of a single business through a newly created subsidiary. It is hoped either that the courts will strengthen these provisions to cover this area, as Congress surely would have had it considered the problem, or Congress will return again to this area.

\textbf{D. Disadvantages of Rollover IRA's}

Rollover IRA's present two principal disadvantages. The first is the difficulty, previously discussed, in meeting the stringent definition of a qualifying lump-sum distribution in order to first establish the IRA. The second is the obverse side of the lump-sum distribution coin. Code section 402(e)(4)(A) limits favorable lump-sum distribution treatment to a trust forming a part of a plan described in section 401(a). In short, an IRA, which is described in section 408, cannot obtain lump-sum distribution

\textsuperscript{163} I.R.C. §§ 402(a)(6)(B) (flush language), 403(a)(5)(B) (flush language).

\textsuperscript{164} See I.R.C. § 368(a)(1)(D), 355.

\textsuperscript{165} However, it may be argued that the creation of one or more subsidiaries creates the requisite controlled group relationship, albeit ephemeral, which is terminated by reason of the spin-off, split-off, or split-up.
treatment. Congress intentionally denied capital gains and the special separate basket ten-forward averaging to encourage use of IRA’s for retirement.

The Tax Reform Act of 1976 allows exclusion from the gross estate of a survivor’s interest in an IRA, as long as it is payable over at least a three-year period. Inexplicably these exclusions in the case of a qualified plan (including H.R. 10 plans) are denied only to lump-sum distributions. This provision applies to decedents dying and gifts made after December 31, 1976.

E. Alternatives to IRA’s for Deferral of Taxation

Code section 72(h) provides that if a “contract” provides for full payment in a lump-sum with an option to receive an annuity instead, and the distributee exercises such option within sixty days after the lump-sum first becomes payable, the constructive receipt rules are legislatively waived so that the lump-sum payment is not included in gross income at the time it first becomes payable. The regulation by and large rephrases the statute, except that it adds a highly significant requirement that the election be made prior to receiving any portion of the lump-sum. However, the Service has ruled that where an employee exercises

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188 The harder question is whether amounts which are rolled from a conduit IRA into a subsequent qualified plan trust are eligible for the capital gains and ten-year forward averaging provision of section 402 upon a subsequent distribution. See McKinney, An Analysis of the New Expanded Roll-Over Rules for Terminating Qualified Plans, 45 J. Tax. 10 (July, 1976). One commentator believes that they will. See Gilchrist, (ERISA) — Plan Terminations: Corporate Acquisitions (US), 312 Tax Mngm’t, A-20 (1976).


190 I.R.C. § 2039(e); Tax Reform Act of 1976 § 2009(c)(1).

191 I.R.C. § 2039(c); Tax Reform Act of 1976 § 2009(c)(3).

192 Tax Reform Act of 1976 § 2009(e)(3). I.R.C. § 2039(c), prior to the Tax Reform Act of 1976, provided an exemption from the estate tax of the value of an annuity or other payment receivable by any beneficiary (other than the executor of the participant’s estate) under an exempt employee’s trust, a retirement annuity contract purchased by the employer as a part of a qualified annuity plan, or a deferred annuity contract purchased by a tax-exempt organization as the employer. There was no reference to an IRA under I.R.C. § 408. Accordingly, there was no exemption for the value of an IRA. Similarly, I.R.C. § 2517 provided an exemption from the gift tax as to the exercise or non-exercise by an employee under an exempt employee’s trust, an I.R.C. § 403(a) annuity plan, or a deferred annuity purchased by a tax-exempt employer of an election or option whereby an annuity or other payment would become payable to any beneficiary at or after the employee’s death. Again, there was no reference to I.R.C. § 408, and consequently any election would have triggered a gift tax. This was not an academic situation since a joint and survivor annuity election as to an IRA would have constituted a taxable gift since there was no exclusion under § 2517.

193 I.R.C. § 72(h).

194 Treas. Reg. § 1.72-12 (1960).
an election within sixty days after termination of service to have the trustee of a qualified plan purchase for and transfer to him an annuity in lieu of a lump-sum distribution, section 72(h) applies and no part of the lump-sum is included in his gross income at the time the sum first becomes payable. Additionally, if a qualified plan trust purchases an annuity contract for an employee and distributes it to him, if the contract is transferable, within sixty days it must be made nontransferable. Both of these provisions require that the contract be distributed by the trust. A contract may be distributed by the trust with so many provisions and options available to the employee that it is almost the equivalent of cash. In this event he may elect to forego these rights within sixty days after receipt and defer taxation. By analogy, he should be allowed to take actual cash received and within sixty days purchase an annuity contract. But there is no direct authority on this point. In any event, it is worth noting that the annuity contract approach does not require a separation from service. Of course, estate and gift tax exclusions apply to an annuity contract distributed by the trust.

It may be possible to terminate a trusteed plan, either a defined contribution or defined benefit plan, and apply all of the assets to purchase individual annuity contracts and then after the distribution treat the “plan” as an annuity contract plan under section 403 with all of the benefits of a “qualified plan.” In Estate of Benjamin v. Commissioner, the Seventh Circuit affirmed the Tax Court’s conclusion that the termination of a trusteed defined benefit plan (funded through individual annuity contracts for each employee) and the distribution of annuity contracts to the participants constituted a conversion into a nontrusteed annuity contract plan so as to entitle the taxpayer to capital gains treatment (under pre-ERISA and pre-1969 law) upon surrender of the annuity contract after the death of the participant by virtue of section 403(a)(2). There is an implication, however, in the Benjamin case, that the employer intended to continue making contributions to the annuity plan.

A plan may be terminated while the trust is continued in existence and distributions are made from the trust upon the occurrence of stated events under the plan, such as death and

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175 465 F.2d 982 (7th Cir. 1972).
176 Id. at 987.
retirement of participants. In such instances the "frozen" trust is treated as any other qualified trust and the same favorable tax consequences attach.\textsuperscript{177} The Internal Revenue Service is not applying the doctrine of "constructive receipt" in allowing employees of a one-time irrevocable election upon termination of a qualified plan to either receive a distribution immediately or defer it under the trust until death, retirement, etc.\textsuperscript{178}

There are administrative disadvantages to continuing a wasting trust, however, in that reporting will continue to be required by the Department of Labor and there are continuing fiduciary responsibilities—perhaps the very factors that led the plan sponsors to terminate the plan in the first place.

III. IN-SERVICE WITHDRAWALS

Complex rules are involved whenever an employee makes an in-service withdrawal from his account in a qualified plan. Differing factors may be involved depending upon whether it is employer, or employee, contributions that are withdrawn.

A. Withdrawal of Employer Contributions

The regulations state that a profit-sharing plan (which is primarily a plan of deferred compensation) must provide a definite predetermined formula for allocating employer contributions among participants and for distributing the accumulated trust funds after a fixed number of years, the attainment of a stated age, or upon the prior occurrence of some event (such as lay-off, illness, disability, retirement, death or severance of employment).\textsuperscript{179} The term "fixed number of years" means at least two years.\textsuperscript{180} Thus, a profit sharing plan may provide for distribution of employer contributions out of funds that have aged for at least two years. In addition, a qualified profit-sharing plan may permit participants to withdraw all their share of employer contributions, even including those which have been made within the last


\textsuperscript{178} McKinney, An Analysis of the New Expanded Roll-Over Rules for Terminating Qualified Plans, 45 J. Tax. 10 (July, 1976). See Ltr. Rul. 7,744,013 (1977); Ltr. Rul. 7,736,019 (1977). Some practitioners, in a desire to avoid constructive receipt or "made available" problems, may provide that all low paid employees are to be cashed out upon a termination, while the highly paid are to remain in a wasting trust. This approach arguably provides different investment media for the low paid and for the chiefs, which may constitute discrimination in operation.


two years. 181 If a participant applies for a withdrawal which is approved by the plan administrator and then does not withdraw the total amount approved, he nevertheless is taxed on the full amount under the "made available" or constructive receipt doctrine. 182 This is true even where the plan provides a suspension of participation for six months upon each withdrawal, and a similar suspension upon withdrawal of the balance. 183 Stock bonus plans are subject to identical rules in this context.

Money purchase pension plans and defined benefit pension plans may not provide for such withdrawals under the rationale that such plans must be established and maintained by an employer "primarily" to provide systematically for the payment to employees of definitely determined benefits after retirement over a period of years, usually for life. 184 "Primarily", according to the IRS, means that while such a plan is not precluded from being qualified merely because it provides benefits prior to normal retirement, such as disability or death benefits, such benefits must be only incidental to the main "retirement" purpose of the plan. 185 Thus, a pension plan that permits participants prior to severance of employment, retirement, disability or death to withdraw all or a part of their accrued benefit is inconsistent with the IRS's concept of a pension plan. 186 Similarly, a money purchase pension plan fails to qualify if it permits loans to participants and then provides for deduction from their accounts of any unpaid loan balance after two years. The so-called "loans" are considered "distributions" due to the tacit understanding that collection is not intended or that the transaction does not create a true debtor-creditor relationship. 187

In the case of an integrated profit-sharing plan, the Service's posture is that benefits can be provided only upon retirement, death or other separation from service. 188 Accordingly, accelerated payments in an integrated profit-sharing plan cannot be made even as to the nonintegrated portion, according to the Service. 189

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185 I.R.C. § 401(h).
189 Goodman, Questions and Answers Following Talk on Developing Pension and
Nonintegrated stock bonus and profit-sharing plans may provide for accelerated distributions because of hardship, provided that "hardship" is defined, and the governing rules are uniformly and consistently applied, and the distributable portion does not exceed the employee's vested interest. The Service has approved a definition of hardship as "circumstances of sufficient severity that a participant is confronted by present or impending financial ruin or his family is clearly endangered by present or impending want or privation." Hardship distributions in profit-sharing plans may not be permitted, however, where the plan is integrated.

Frequently, in order to avoid constructive receipt of amounts of employer contributions as to which a participant has a right to withdrawal when he does not in fact make a withdrawal, some pre-ERISA plans subjected the exercise of the right to withdrawal to some form of penalty or restriction. Other approaches were to require an irrevocable election by the employee, prior to the time his interest became distributable, or to have the interest deferred until a fixed or determinable future time, such as normal retirement age. Still other approaches were to permit withdrawals only with the approval of an administrative committee and only in the case of proven financial necessity. Some practitioners have raised the question whether a participation penalty for withdrawals is prohibited by the minimum participation requirements of section 410 where the employee completes 1,000 hours of service during the plan year. The regulations state that section 410 relates solely to age and service conditions and does not preclude a plan from establishing conditions, other than related to age or service, which must be satisfied by plan participants. While the examples given speak to specified job classifications, probably a penalty for withdrawal would come...
within this exception. However, if the Service's discrimination in operation approach to a last day rule is valid, it might equally apply here where an employee has completed one thousand hours of service but does not participate in allocations due to such penalty.

B. Withdrawal of Employee Contributions

Under pre-ERISA practice employee voluntary contributions were usually permitted to be withdrawn with no substantial penalties, at least in the nature of forfeitures. Restrictions were often imposed upon withdrawals of growth in order to avoid constructive receipt. However, plans involving mandatory employee contributions to which employer contributions were geared presented quite a different picture. Virtually all pre-ERISA contributory plans provided that if a terminating employee exercised his right to withdraw employer contributions, he would forfeit all rights attributable to employer contributions which have been geared to the employee contributions. This was true even though he had acquired a vested interest in the employer contributions. Terminating employees attracted by lump-sum distributions almost invariably withdrew their own contributions even though they might relinquish deferred benefits attributable to employer contributions with an actuarial value greatly in excess of the employee contributions. The Service has ruled that an immediate withdrawal of employee contributions to which employer contri-

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197 In Rev. Rul. 76-250, 1976-2 C.B. 124, the Service acknowledged that in a contribution plan allocations could be conditioned upon employment of the last day of the plan year. But the Service announced for the first time that such a provision could result in discrimination in operation. For a discussion of the background of this ruling, the underlying Code provisions, and the controversy surrounding the antidiscrimination provision in the last day rule, see Lee, supra note 5, at 411-16.

198 See Rev. Rul. 76-250, 1976-2 C.B. 124. In other words, employees who make such withdrawals might be deemed to have received a zero contribution as to the penalty period since they remain "participants" within the ERISA definition unless they have incurred a one year break in service. Then should their zero allocations produce a lower percentage compensation contribution for the "Indians" as contrasted with the percentage of compensation contribution of the "Chiefs," the plan, under the Rev. Rul. 76-250 rationale, could be disqualified in operation. Since withdrawals by participants apparently occur primarily among younger employees who tend more towards Indians than Chiefs, see D. McGill, supra note 10, at 128 n.2. The problem of discrimination in operation may be real here. Consequently, the election to defer prior to the contribution becoming nonforfeitable appears a safer course to pursue than participation penalties. However, the elective nature of the participation penalty upon withdrawal may distinguish this case from the Rev. Rul. 76-250 situation.


200 Id.
Contributions were geared without forfeiture of employer contributions would permit manipulation of allocation of the geared employer contributions and contravene, as well, the requirement of a definite predetermined allocation formula. On the other hand, where geared employer contributions were forfeited upon a withdrawal by the employee of his own contributions, the Service reasoned that willingness to forfeit the geared employer contribution evidenced a financial need so that the plan qualified as one containing a provision permitting a participant to withdraw employee contributions upon a stated event, i.e., at a time of financial need.

The Senate bill provided that a qualified plan trust would not be disqualified merely because an employee’s rights to his accrued benefit derived from employer contributions under the plan were forfeitable, if, by reason of his separation from service or termination or active participation in the plan, he voluntarily withdrew all or part of the mandatory contribution made by him. The Senate was very concerned, however, that an employee withdrawing his own mandatory contributions be made fully aware of the consequences of doing so and expected the Service and the Labor Department to coordinate efforts requiring plans containing such forfeiture clauses to make full and adequate disclosure to the employee prior to withdrawal, including disclosure of the current value of the accrued benefit the employee will forfeit and (at least in the case of a defined benefit plan) the amount of pension he could expect to receive at normal retirement.

The House bill did not express a view as to whether mandatory employee contributions or the right to withdraw such contributions were desirable features of retirement plans, but it specifically required all qualified plans to forbid forfeitures of nonforfeitable benefits derived from employer contributions solely because of withdrawals by employees of any part of the benefits derived from the employee’s contributions.

Congress adopted a position permitting forfeiture of employee’s rights to benefits derived from employer contributions

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205 Id. at 49-50.
where the employee withdraws all or any part of his own mandatory contributions to the plan. But this can be done only if he is less than fifty percent vested in his benefits. 207 Additionally, the plan must provide a "buy-back" rule, under which an employee's forfeited benefits can be fully restored if he repays the withdrawn contributions (with interest at five percent in a case of a defined benefit plan). 208 In addition to granting such a "forfeiture" of otherwise nonforfeitable benefits in section 411, a trust cannot be qualified under section 401(a)(19) if it permits a forfeiture of employer accrued benefits solely because of withdrawal of employee contributions unless at the time of the withdrawal the participant had a nonforfeitable right to less than fifty percent of his accrued benefit, as determined under section 411. 209

Query, whether this cross-reference in section 411(a)(19) is sufficient to incorporate the class-year-by-class-year approach of section 411(a)(3)(d)(iv). The latter provision does not really deal with accrued benefits. This gap further supports the argument that the matured classes must be measured against the immature classes as a whole in application of the fifty percent test rather than looking to each class year separately. 210

The cash-out and buy-back provisions are substantially the same for the withdrawal of mandatory contributions and for distributions upon a separation from service except that, significantly, a defined contribution may provide in lieu of the forfeiture and restoration, i.e., cash-out and buy-back, that a forfeiture does not occur until the expiration of the time for repayment of the withdrawal. 211 This delayed forfeiture is not available under the cash-out and buy-back rules for distribution upon separation

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210 The regulations do not clarify this situation; they merely state that a qualified plan cannot permit forfeiture of geared employer contributions solely by reason of a withdrawal of mandatory contributions after a participant has become a "50 percent vested participant." Treas Reg. § 1.401(a)-19(b)(1)(1966). The latter term is defined as occurring when a participant has a "nonforfeitable right (within the meaning of I.R.C. § 411 and the regulations thereunder) to at least 50 percent of his accrued benefit derived from employer contributions." Treas. Reg. § 1.401(a)-19(b)(2)(1966). Again, there is no reference in this context to the class-year-by-class-year approach, as is the case in the withdrawals provision under § 411. These provisions leave open the question of the continued validity of Rev. Rul. 72-275, note 202 supra, where the participant is more than 50% vested and he makes a withdrawal.
212 See I.R.C. § 411(a)(3), which provides for certain permitted forfeitures upon the occurrence of certain stated events including withdrawal of mandatory employee contributions. See also H.R. REP. No. 93-1280, 93d Cong., 2d Sess. 271 (1974).
from service, as opposed to in-service withdrawals, where it would solve many problems. The apparent reason is that the withdrawal of mandatory contributions is a specific statutory exception to the statutory requirement that a benefit be nonforfeitable under the minimum vesting rules, whereas the cash-out and buy-back rules only deal with computing the accrued benefit. This appears to have been a meaningless distinction in Congress' eyes. Special rules apply to post-ERISA withdrawal of mandatory contributions which had been made to the plan prior to September 2, 1974. Accordingly, prudence dictates that years of service as to which a withdrawal of mandatory employer contributions has been made continue to be counted for purposes of vesting unless some exception other than Code section 411(a)(4)(B) applies.

CONCLUSION

As this article amply demonstrates the tax rules governing pre-retirement distributions are incredibly and indeed overly complex. Moreover, when the breaks in service and forfeiture rules are coupled with various methods for determining credited service, utter chaos too frequently arises in plan administration. Those plans utilizing the standard hours of service approach frequently and inadvertently fail to follow plan terms. The task is somewhat easier for certain elapsed time plans, but those regulations were promulgated woefully late for those practitioners who had conscientiously brought their plans under ERISA in a timely fashion. These inadvertent, probably inevitable, mistakes are rendered deadly by certain recent trends, particularly in the Tax Court, of disqualifying plans for inadvertent mistakes. It is to

211 See Lee, supra note 5, at 446.
212 Id. Also the Conference Report in describing the "permitted forfeitures" mentioned in note 204, lists the general cash-out and buy-back rules along with the specific exceptions to the minimum vesting requirements set forth in I.R.C. § 411(a)(3).
213 A right to a benefit attributable to employer contributions accrued prior to September 2, 1974, is not treated as forfeitable merely because all or a part of such pre-ERISA accruals may be forfeited on account of withdrawal by a participant of an amount attributable to his benefits derived from mandatory contributions made by him before ERISA so long as the amount of pre-ERISA accruals derived from employer contributions is no more than proportional to the amounts withdrawn. Treas. Reg. § 1.411(a)-7(d)(3)(i)(1977). This special rule does not apply to any plan to which mandatory contributions are made after September 2, 1974. The methods for determining the portion of benefits which accrued before ERISA and which were attributable to employer contributions are set forth in Treas. Reg. § 1.411(a)-7(d)(ii), (iii)(1977).
214 See Forsyth Emergency Services, P.A., 68 T.C. 482 (1977), and Allen Ludden, 68 T.C. 453 (1977). The authors feel that these cases are unrealistic and hopefully will be
be hoped that the Service and the Department of Labor in auditing qualified plans will take into account the complexities of administration under the new payout and forfeiture rules. Unfortunately, many small plans would probably terminate rather than undergo another round of amendments to adopt more manageable rules. And this assumes that the rules, as of the time this article was prepared are final—hardly a wise assumption, particularly in light of the hints by some members of the Tax Court that certain aspects of the elapsed time regulations are invalid.217

overturned. Perfection in administration should not be expected. Only when intentionally discriminatory “mistakes” are made should plans be disqualified.