1994

Qualified Retirement Plans: What Practitioners Need to Know

Michael L. Layman

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QUALIFIED RETIREMENT PLANS: WHAT PRACTITIONERS NEED TO KNOW

INITIAL FACT PATTERN

Dr. James Madison is a plastic surgeon, age 50. He currently owns 100% of his professional practice which is incorporated. He has made $250,000 in his practice for the last several years. His employees are:

<table>
<thead>
<tr>
<th>Name</th>
<th>Position</th>
<th>Customary Hours</th>
<th>Years of Service With Corporation</th>
<th>Years of Service With Predecessor Sole Prop</th>
<th>Age</th>
<th>Pay</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>Receptionist</td>
<td>&gt;1000</td>
<td>3</td>
<td>0</td>
<td>50</td>
<td>$15,000</td>
</tr>
<tr>
<td>B</td>
<td>Nurse</td>
<td>&gt;1000</td>
<td>3</td>
<td>4</td>
<td>45</td>
<td>$25,000</td>
</tr>
<tr>
<td>C</td>
<td>File Clerk</td>
<td>&gt;500 but &lt;1000</td>
<td>3</td>
<td>1</td>
<td>40</td>
<td>$15,000</td>
</tr>
<tr>
<td>D</td>
<td>Nurse</td>
<td>&lt;500</td>
<td>3</td>
<td>0</td>
<td>35</td>
<td>$10,000</td>
</tr>
<tr>
<td>E</td>
<td>Bookkeeper</td>
<td>750</td>
<td>1</td>
<td>0</td>
<td>30</td>
<td>$ 8,000</td>
</tr>
<tr>
<td></td>
<td>Mrs. Madison</td>
<td>400</td>
<td>3</td>
<td>8</td>
<td>45</td>
<td>None</td>
</tr>
</tbody>
</table>

Dr. and Mrs. James Madison live on a horse farm, and Mr. Bill Hand, age 30, has been the full-time farm employee for six (6) years. Despite spending a lot of money on the horse farm, it has never shown a profit and their accountant and tax advisor, Mr. Straight Arrow, CPA, is worried about the hobby loss rules, and whether the loss of the farm can continue to offset other income.

Mrs. James Madison employs a full-time baby sitter and maid who is age 30 and works 2000 hours a year at their home.

I. ORGANIZATIONAL ISSUES.

A. Coverage.

1. Family Aggregation.

   a. Impact on Compensation and Plan Allocations. Dr. Madison has an integrated money purchase pension plan and wants to know whether he should pay his wife a salary of $20,000 a year and reduce his accordingly? How is the retirement plan allocation properly made between Dr. Madison and his wife if his pay for 1994 is $230,000 and his wife's pay is $20,000.
b. **What is the Family Aggregation Rule?** If an individual is a member of the family of either a 5 percent owner; or a highly compensated employee who is one of the ten most highly compensated employees, the compensation of that individual is treated as if paid to (or on behalf of) a single 5 percent owner or highly compensated employee. Family members include the employee’s spouse and any lineal descendant who has not attained age 19 before the close of the year. I.R.C. Secs. 401(a)(17), 414(q)(6); Treas. Reg. Secs. 1.401(a)(17)-1(b)(5).

**Example.** The Dolly Madison Group, Inc., adopted a 25-percent-of-compensation money purchase pension plan for calendar year 1993. There were two participants, James, who earns $235,840, and his wife, Dolly, who also earns $235,840. Because of the family aggregation rule, their combined compensation cannot exceed $235,840. The contribution for each is as calculated as follows for 1993:

1. Each is deemed to earn $117,920 ($235,840 ÷ 2).
2. The contribution for each is $29,480 (25% X $117,920).
3. The total contribution is $58,960 ($29,480 + $29,480).

If the family aggregation rule did not apply, the total contribution would have been on $60,000 [(lesser of $30,000 or 25% X $235,840) X 2]. The family aggregation rule does not apply to the annual addition limitation, nor does it apply to the limitation on the annual retirement benefit that a defined benefit plan may provide.

The reduction in the annual compensation limitation to $150,000 in 1994 reduces James and Dolly’s total contribution to $37,500 [($150,000 ÷ 2) X 25% X 2]. However, TSB '93 as proposed contains a provision repealing the family aggregation rule and, if enacted, would increase James and Dolly’s total contribution in 1994 to $60,000 [(lesser of $30,000 or 25% X $150,000) X 2]. [TSB '93, Act Section 221(c)].

c. **Impact of Various Compensation Levels on Plan Allocations.**

<table>
<thead>
<tr>
<th></th>
<th>James</th>
<th>Dolly</th>
</tr>
</thead>
<tbody>
<tr>
<td>Situation #1</td>
<td>$230,000</td>
<td>$20,000</td>
</tr>
<tr>
<td>Situation #2</td>
<td>$150,000</td>
<td>$150,000</td>
</tr>
<tr>
<td>Situation #3</td>
<td>$85,000</td>
<td>$85,000</td>
</tr>
</tbody>
</table>

What is the correct allocation if the money purchase pension plan calls for a 5.7% excess of social security wage base contribution,
plus 10% of total pay contribution.

(1) Situation #1.

$150,000
$230,000 X $250,000 = $138,000 - $60,600
OR ($60,600)
$150,000

$20,000
$20,000
$20,000 X $250,000 = $12,000 - $60,600
(Therefore, no amount above wage base)

So, do you subtract the $60,600 wage base against $138,000 and $12,000, or just once against $150,000? If plan document does not contain clear language, "fuzzy" language of I.R.C. Sec. 414(q) appears to allow an offset of $60,600 only once against the $150,000 limit since one family member in fact exceeds the $150,000 limit.

(2) Situation #2. Again, allocation would be based on the situation as if just one employee was involved; therefore, $150,000 - $60,600 would be the initial step in the allocation and not ($75,000 - $60,600) and ($75,000 - $60,600).

(3) Situation #3. Unlike Situation #1 and Situation #2 where one family member exceeded the $60,600; here neither family member exceeds the $150,000.

Choices with Situation #3. Total compensation of family members in excess of $60,600 is:

$85,000
(60,600)
$24,400 + $24,400 = $48,800

So, one could argue that family members (husband and wife) should benefit by excess allocation of 5.7% on total pay above $60,600; followed by proportionate reduction by the fraction $150,000 / 170,000:
10% X $85,000 = $ 8,500
5.7% X $24,400 = $ 1,390

$ 9,890
X 2 people

$19,780

$150,000/$170,000 X $19,780 = $17,453.87

VERSUS

Reduce each spouse’s pay proportionately until combined pay equals $150,000 instead of $170,000 and apply social security integration of $60,600 separately to each.

$85,000 ---> $75,000  $85,000 ---> $75,000
(60,600)        (60,600)

$14,400         $14,400

So, one could argue proper contribution is 10% X $75,000, plus 5.7% X $14,400 multiplied by 2, which equals $16,640.

VERSUS

Reduce each pay proportionately until combined pay equals $150,000 instead of $170,000 and also proportionately reduce the $60,600 (the wage base)

11.76%          11.76%
$85,000 ---> $75,000  $85,000 ---> $75,000
$60,600 ---> $53,474  $60,600 ---> $53,474

$21,526         $21,526

So, one could argue the proper allocation is 10% X $75,000 and 5.7% X $21,526 multiplied by 2, which equals $19,906.

VERSUS

But, if the purpose of the legislation is to aggregate the pay as if earned by one person, and total pay is $170,000, then would not the proper allocation be:
$15,000

$5,095

$20,095

$20,095 divided equally between the two spouses.

2. **Farm Employee vs. Household Employee.** Must Dr. Madison’s plan cover his farm employee? **YES,** if necessary to satisfy the 70% coverage rules of I.R.C. Sec. 410(b).

   Must Dr. Madison’s plan cover his full-time household employee? If not, could he elect to if he wanted? **NO,** not a trade or business employee. See I.R.C. Sec. 414(c).

3. **Employee vs. Independent Contractor.**

   a. **Impact on Plan Funding.** Could (or should) Mrs. Madison set up a separate consulting business and contract as an independent contractor with Dr. Madison’s practice to increase her ability to fund for retirement?

      Rev. Rul. 57-109, 1957-1 C.B. 328, concluded that a part-time bookkeeper was an independent contractor even though the services were provided on corporation’s premises. However, no regular hours were prescribed, bookkeeper provided all materials and paid related expenses, the bookkeeper had a home business office, advertised in city directory, newspapers, and had a regular clientele of business firms. Better to be safe than sorry here.


   b. **The IRS and Physicians.** A public health agency engaged a physician to work in its psychiatric facility. The physician is to provide personal medical services to the agency as "office of the day/night," a position that requires him to be on call for consultations or evaluations. The services are performed at the agency’s facility in respect to medical emergencies. The physician is not required to provide any material, equipment, or supplies, and he is not supervised. He is paid by the hour and is not covered by worker’s compensation. The physician devotes 10% of his work time to the agency. The remainder of the time he spends in his private practice.

      The IRS has ruled that the physician is the agency’s employee for federal income tax withholding purposes. Citing Rev. Rul. 61-178,
1961-2 C.B. 153, the IRS concluded that the degree of control retained by the agency over the physician’s work established an employer-employee relationship. See PLR 9241026 (July 10, 1992).

4. **Locum Tenums/Employee vs. Independent Contractor.**
Dr. Madison hires Dr. Patrick Henry as a locum tenens for four (4) months, while he takes a four (4) month leave of absence. What issues arise?

(1) Is Dr. Henry an employee or an independent contractor?

(2) How long would Dr. Henry need to serve as a locum tenens before he would be considered an employee?

The answers are not easy. We are aware that the IRS is quite aggressive in stating that military doctors serving as locum tenens on weekends regularly for physician groups should be treated as employees.

If the temporary physician might satisfy plan eligibility requirements, consider having the physician elect out of the plan to avoid problems.

5. **Controlled Group Issues.**

a. **One Owner - Multiple Businesses.** If Dr. Madison owns 100% of the corporate medical practice and 100% of an unincorporated farm operation, the employees of both must be considered for plan coverage purposes. Section 410 requires that coverage ratio for NHCEs be at least 70% of coverage ratio of HCEs.

b. **Impact of Additional Shareholder.** If Dr. Madison is thinking about Dr. Jefferson buying into the medical practice, does it make any difference whether Dr. Jefferson buys:

(1) 20% interest (Situation #1).

(2) 50% interest (Situation #2).

(3) 49% interest (Situation #3).
### Situation #1*

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Sole Pro. Farm</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison</td>
<td>80%</td>
<td>100%</td>
</tr>
<tr>
<td>Jefferson</td>
<td>20%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

*Under Common Control

### Situation #2**

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Sole Pro. Farm</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison</td>
<td>50%</td>
<td>100%</td>
</tr>
<tr>
<td>Jefferson</td>
<td>50%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

**Not Under Common Control

### Situation #3***

<table>
<thead>
<tr>
<th>Corporation</th>
<th>Sole Pro. Farm</th>
<th>Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison</td>
<td>51%</td>
<td>100%</td>
</tr>
<tr>
<td>Jefferson</td>
<td>49%</td>
<td>0%</td>
</tr>
<tr>
<td></td>
<td>100%</td>
<td>100%</td>
</tr>
</tbody>
</table>

***Under Common Control

Therefore, for Madison to avoid having to consider his farm employees for coverage purposes, he would want to limit his ownership of the professional practice to 50%.

What if Dr. Madison operated his medical practice in partnership form? Would the "controlled group" result be the same? **YES.** See I.R.C. Sec. 401(d) which creates an even earlier controlled group rule for owner-employee entities and then compare with I.R.C. Sec. 414(b); also read I.R.C. Sec. 414(c).
EXAMPLES

<table>
<thead>
<tr>
<th>Partnership M-J</th>
<th>Partnership M-P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison 50%</td>
<td>Madison 50%</td>
</tr>
<tr>
<td>Jefferson 50%</td>
<td>Henry 50%</td>
</tr>
</tbody>
</table>

*Note: Owner/Employees is a sole proprietorship or partner owning or partner owning more than 10% in capital or profit interests.

NOT A CONTROLLED BUSINESS
(NO PERSON OR GROUP OWNS >50%)

<table>
<thead>
<tr>
<th>Partnership M-J</th>
<th>Partnership M-P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison 51%</td>
<td>Madison 51%</td>
</tr>
<tr>
<td>Jefferson 49%</td>
<td>Henry 49%</td>
</tr>
</tbody>
</table>

A CONTROLLED BUSINESS

<table>
<thead>
<tr>
<th>Corporation M-J</th>
<th>Corporation M-P</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison 51%</td>
<td>Madison 51%</td>
</tr>
<tr>
<td>Jefferson 49%</td>
<td>Henry 49%</td>
</tr>
</tbody>
</table>

AGAIN, IF THE BUSINESS IS INCORPORATED, IS IT CONTROLLED NOW? YES

Same 5 or fewer persons own ≥ 80% of both entities and identical ownership is greater than 50%.

Do these same person have effective control (>50%) to the extent of their identical interests? YES

<table>
<thead>
<tr>
<th></th>
<th>AB</th>
<th>AC</th>
<th>Identical</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>51%</td>
<td>51%</td>
<td>51%</td>
</tr>
<tr>
<td>B</td>
<td>49%</td>
<td>0%</td>
<td>0%</td>
</tr>
<tr>
<td>C</td>
<td>0%</td>
<td>49%</td>
<td>0%</td>
</tr>
</tbody>
</table>

100% 100% 51%
c. **Significance of Choice of Entity.** When does the type of entity make a difference?

<table>
<thead>
<tr>
<th></th>
<th>Entity X</th>
<th>Entity Z</th>
<th>&gt;50% Ownership Test</th>
</tr>
</thead>
<tbody>
<tr>
<td>Madison</td>
<td>51%</td>
<td>51%</td>
<td>51%</td>
</tr>
<tr>
<td>1</td>
<td>5%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>2</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>3</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>4</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>5</td>
<td>11%</td>
<td></td>
<td></td>
</tr>
<tr>
<td>6</td>
<td></td>
<td>5%</td>
<td></td>
</tr>
<tr>
<td>7</td>
<td></td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>8</td>
<td></td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>9</td>
<td></td>
<td>11%</td>
<td></td>
</tr>
<tr>
<td>10</td>
<td></td>
<td></td>
<td>11%</td>
</tr>
</tbody>
</table>

100% 100% 51%

But, ≥80% test is not satisfied by the same 5 or fewer persons. Therefore, if a corporation, not controlled; but, if a partnership, what does I.R.C. Sec. 401(d) say? There is the ≥50% test in I.R.C. Sec. 401(d)(1)(8), but no 80% test as in I.R.C. Sec. 1563.

What if Entity X and Entity Z are partnerships and are under common control, and Y is a farm. If there is no earned income allocated to the owners-employees of Y; must the employees of Y be covered under the partnership X’s plan? YES. See I.R.C. Sec. 1.401-12(1)(3).

d. **I.R.C. Sec. 401(d). Additional Requirements for Qualification of Trusts and Plans Benefiting Owner-Employees.** Plans providing contributions or benefits to owner-employees who control one or more trades or businesses will be considered a single plan for purposes of I.R.C. Sec. 401(a).

What is control for purposes of I.R.C. Sec. 401(d)? An owner-employee, or two or more owner-employees, shall be considered to control a trade or business if such owner-employee, or such two or more owner-employees together satisfy one of two requirements. First, the owner-employee(s) must own the entire interest in an unincorporated trade or business; or, second, in the case of a partnership, the owner-employee(s) must own more than 50% of either the capital interest or the profits interest in such partnership. I.R.C. Sec. 401(d)(1)(B).
e. I.R.C. Sec. 414(b). Employees of Controlled Group of Corporations. For purposes of I.R.C. Secs. 401, 408(k), 410, 411, 415, and 416, all employees of all corporations which are members of a controlled group of corporations (within the meaning of I.R.C. Sec. 1563(a), determined without regard to I.R.C. Secs. 1563(a)(4) and (e)(3)(C)) shall be treated as employed by a single employer. With respect to a plan adopted by more than one such corporation, the applicable limitations provided by I.R.C. Sec. 404(a) shall be determined as if all such employers were a single employer, and allocated to each employer in accordance with regulations prescribed by the Secretary.

f. I.R.C. Sec. 414(c). Employees of Partnership, Proprietorships, Etc., Which are Under Common Control. For purposes of I.R.C. Secs. 401, 408(k), 410, 411, 415, and 416 under regulations prescribed by the Secretary, all employees of trades or businesses (whether or not incorporated) which are under common control shall be treated as employed by a single employer. The regulations prescribed under this subsection shall be based on principles similar to the principles which apply in the case of I.R.C. Sec. 414(b).

6. Expense Sharing Arrangements. True office sharing arrangement, where personal service businesses share expenses, but not income, and, therefore, are not partnerships, appears exempt from affiliated service group rules. Rev. Rul. 67-101, 1967-1 C.B. 82, as amplified by Rev. Rul. 68-391, 1968-2 C.B. 180, Rev. Rul. 73-447, 1973-2 C.B. 135, Rev. Rul. 81-105, 1981-1 C.B. 256, obsoleting Rev. Rul. 68-370, 1968-2 C.B. 174, Rev. Rul. 86-41, 1986-1 C.B. 300. In general, an employer should treat a shared employee as its employee for ERISA requirements if the employer pays "directly or indirectly" the share employee's pay, provided the shared employee works 1000 hours for all recipient employers (although arguably the shared employee should have to work 1000 hours for the employer (but be conservative here)). If the plan is integrated, proportionately prorate the integration level.

7. Affiliated Service Groups and Hospital-Based Physicians. The withdrawal of proposed regs. (P.R. 1.414(m)-5 and -6) should alleviate concern for application of I.R.C. Sec. 414(m)(5) rules to a qualified plan maintained by a hospital-based physician who performs only medical services under contract with a hospital. But, if a hospital-based physician regularly receives the service of hospital employees, those employees may be leased employees under I.R.C. Sec. 414(n).

8. Leased Employee Rules. A billing service company, Blue Bill Collections, comes to Dr. Madison with the suggestion that Blue Bill do all billing and collection work for the professional corporation. Blue Bill will hire the bookkeeper away from the professional corporation. The
bookkeeper will work on the professional corporation’s billings and accounts receivable at a new office rented by Blue Bill where other employees of Blue Bill do billing and collection work for a large number of clientele.

What issues arise?

Is the bookkeeper a "leased employee" under I.R.C. Sec. 414(n)?

Can Blue Bill have a 10% money purchase pension plan ready for the bookkeeper in order to avoid coverage problems?


(1) Applicability. I.R.C. Sec. 414(n) applies to "leased employees." A leased employee is anyone who provided services to a "recipient" if the following conditions are met:

(a) Agreement. The services are provided under an agreement between the recipient and the leasing organization.

(b) One-Year Rule. The employee has performed services for the recipient or related person on a "substantially full-time basis" for "a period of at least one year." But only six months are required for "core health benefits." I.R.C. Sec. 414(n)(2)(B).

(c) Historical Factors. The services are of a type "historically performed in the business field of the recipient, by employees." I.R.C. Sec. 414(n)(2)(C).

(d) Legislative History. The leased employee rules were first enacted as part of TEFRA, effective for taxable years beginning in 1984. The Tax Reform Act of 1986 amended these rules in several respects and extended them from retirement plans only to also include welfare benefit plans. On August 27, 1987, proposed regulations were issued. On April 27, 1993, the regulations were withdrawn.

(2) Leased Employee Consequences.

(a) Employee of Recipient. Any leased employee meeting the above test is the employee of the
recipient for pension purposes. Years of service with the recipient are determined by taking into account the entire period for which the employee performed services for the recipient. I.R.C. Sec. 414(n)(4)(B).

(b) Pension Consequences. A leased employee is treated as an employee for pension purposes under the following pension sections of the Code: I.R.C. Secs. 401(a)(3), (4), (7), (16), (17), and (26); and 408(k), 410, 411, 415, and 416.

b. Safe Harbor.

(1) Statutory Exception. None of the leased employee consequences above apply if the requirements outlined below are met. I.R.C. Sec. 414(n)(5).

(2) A money purchase pension plan, without integration, with a minimum contribution rate of at least 10%, with immediate participation (by all employees except those who perform substantially all of their services for the leasing organization), and with 100% vesting, maintained by the leasing company, means the employees will be employees of the leasing company for retirement plan purposes and not other fringe benefit purposes. I.R.C. Sec. 414(n)(5). However, this exception is only available if leased employees do not constitute more than 20% of the recipient’s non-highly compensated work force. I.R.C. Sec. 414(n)(5)(A)(ii).

9. Participation/Election Not To Participate. Dr. Thomas Jefferson, who has worked at the UVA hospital as a plastic surgeon, says he would like to join the practice and participate immediately in the retirement plan. The plan as written has a two (2) year eligibility waiting period with two (2) entry dates.

What eligibility options are available to the practice?

a. Prior Services Credit. Credit for prior services for predecessor sole proprietorship, partnership, etc. is one option. See Ltr. Ruling 7742003 and Farley Funeral Homes, Inc., 62 TC 150 (1974).

b. Plan Eligibility Requirement. Another option is to shorten the plan’s eligibility requirement by plan amendment.

Assume Dr. Jefferson signs an employment contract to come to work as
an employee on July 4, 1995, but is so enthusiastic that he shows up at the office June 29, 1995, and "volunteers" his time and actually sees patients on the 29th and 30th. If the plan has a two (2) year eligibility waiting period, when is the latest date he must enter the plan?

"Hour of Service" for purposes of eligibility is defined in part to be "each Hour of Service for which the Employee is paid, or entitled to payment, by the Employer for the performance of duties." Using this definition and being comfortable with the fact that we are dealing with a HCE and not a NHCE, then the entry date would be based on service on or after July 4 and not June 28, so entry would be January 1, 1988.

But what if Dr. Jefferson does not want to join the plan for three (3) years because the big house he built on Monticello Lane is going to be difficult to pay for. If Dr. Jefferson signs an agreement not to participate for three (3) years, can he join the plan without problems after three (3) years?

Currently, the IRS says no, and electing out must occur when initially eligible.

If Dr. Jefferson is otherwise eligible, but elects out of participation, how many NHCEs must the qualified plans now cover? 35% of the NHCEs, since only covering 50% of HCEs and need only cover 70% of the HCE percentage.

B. Plan Documents: Prototype, Volume Submitter or Individually Designed.

1. The Alternatives. Dr. Madison, who currently has an individually designed plan document drafted by his lawyer, is trying to decide between adopting a law firm volume submitter plan and a brokerage firm or bank prototype plan to make the necessary plan amendments due before December 31, 1994. What are the primary considerations for Dr. Madison?

2. Primary Considerations.

a. Relative Costs.

(1) Plan Document Costs. Plan document costs will vary significantly depending on type and provider of plan.

(2) IRS User Fee. The amount of the IRS User Fee in connection with the request for a determination letter could vary significantly depending on the type of plan and the type of review requested. See Rev. Proc. 93-39, 1993-31 I.R.B. 7. See also I.R.S. Form 8717.
b. **Investment Options.** Adopting a prototype may restrict investment options.

c. **Plan Provisions.**

(1) **Contributions for Terminated Participant.** Prototype plans often require plan contributions for all terminated participants with more than 500 hours of service. This provision is not necessary in all cases, since only need to satisfy the 70% coverage test. Plan can be written to require contribution for terminated employees only if needed to satisfy the 70% coverage test, and then only add one terminated employee at a time.

(2) **Benefit Curtailment.** In switching from individually designed plan to prototype, make sure no "curtailment of benefits" occur. For example, many prototype plans have less choices regarding distributions.

(3) **Valuation Method.** Prototypes may provide only a single annual valuation. The valuation may be made more often to better handle distribution needs and/or disclosure at retirement, early retirement, termination, disability, and/or death.

(4) **After-Tax Employee Contributions.** If plan provisions require and records are kept, pre-1987 voluntary contributions can be withdrawn first at retirement instead of on a pro-rata basis, along with taxable benefits.

(5) **Life Expectancy Recalculation.** You may want "no recalculation" as the default provision.

(6) **Money Purchase Pension Plan Transferring Assets Into Profit Sharing Plan, and Annuity Requirement.** Plan can require separate accounting for transferred assets to avoid annuity requirement for profit sharing portion of participant's account.

(7) **Administrative Discretion.** Plan language specifically giving the Employer the power to construe the plan and to determine all questions that arise under the plan may assist in avoiding de novo review at the judicial level. See *Firestone Tire & Rubber Co. v. Bruch*, 489 U.S. 101 (1989).
Disability Income Exclusion Under I.R.C. Sec. 105 For Assets Distributed After Disability. Profit sharing plans may provide for not only distributions on disability, but they may also serve as accident or health plans under Treas. Reg. Sec. 1.401-1(b)(ii), with the result that a participant who becomes disabled may be able to receive his entire account balance tax free. This is available only if the plan is written such that:

(a) Plan purpose is to serve as an accident or health plan within the meaning of I.R.C. Sec. 105.

(b) Purpose of benefits is to qualify for I.R.C. Sec. 105 income tax exclusion.

(c) Provisions specify what illnesses and injuries qualify for payments.

See S. Kaplan CA-2, 83-2 USTC ¶9615, and K. Rosen, CA-4, 87-2 USTC ¶9525.

Note: Treas. Reg. Secs. 1.401-1(b)(1)(i) and (ii) suggest both pension plans and profit sharing plans may provide payments for disability.

Spousal Consent. Prototype plans may not allow for irrevocable spousal consent concerning non-spousal beneficiary designations.

Spouse. Plan need only recognize spousal rights after completion of one year of marriage.

Years of Service Credit. Years of Service credit often based on the plan years and not the employee’s employment beginning date in the prototype plans. This leads to crediting two years of service in some cases where only thirteen months of service is provided.

C. The $150,000 Compensation Cap under I.R.C. Sec. 401(a)(17).

1. Impact on Plan Costs. The $150,000 compensation cap increases plan costs since larger contributions are needed for NHCE’s in order to fully fund the HCE’s accounts, but:

a. 401(k) Plans. First, be careful with existing 401(k) plans in order to avoid anti-discrimination tests (ADP and ACP Tests). (Most affected are lower paid HCEs).
b. **Family Aggregation.** Second, note impact on family aggregation rules (See page 1 of this outline).

c. **Pre-1987 Contribution Carry Forwards.** Third, if the business consists of just its owners and therefore only participants are the owners, note that an employer's deduction to a profit sharing plan is limited to 15% of aggregate pay of all plan participants (the 15% limitation). If an employer established a profit sharing plan before the fiscal year beginning in 1987, the employer may have "unused carry forwards" which can increase deduction in 1994 to as much as 25% of the aggregate pay of all plan participants.

<table>
<thead>
<tr>
<th>Year</th>
<th>Pay</th>
<th>Limit</th>
<th>Contribution</th>
<th>Cumulative Unused Carry Forward to Next Year</th>
</tr>
</thead>
<tbody>
<tr>
<td>1984</td>
<td>$300,000</td>
<td>$45,000</td>
<td>$40,000</td>
<td>$5,000</td>
</tr>
<tr>
<td>1985</td>
<td>$350,000</td>
<td>$52,500</td>
<td>$40,000</td>
<td>$12,500</td>
</tr>
<tr>
<td>1986</td>
<td>$400,000</td>
<td>$60,000</td>
<td>$40,000</td>
<td>$32,500</td>
</tr>
<tr>
<td>1987</td>
<td>(LAW REPEALED ON CARRY OVERS, EXCEPT GRANDFATHERED AMOUNTS)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

Therefore, if pay in 1995 to two unrelated owners was $150,000 each, instead of limit for profit sharing plan being 15% \( \times \) $150,000 \times 2 or $45,000; the limit using carry forwards would be:

<table>
<thead>
<tr>
<th>Employee</th>
<th>1994 Pay</th>
<th>Limit</th>
<th>Carryover*</th>
<th>Total</th>
</tr>
</thead>
<tbody>
<tr>
<td>A</td>
<td>$150,000</td>
<td>$22,500</td>
<td>$7,500</td>
<td>$30,000</td>
</tr>
<tr>
<td>B</td>
<td>$150,000</td>
<td>$22,500</td>
<td>$7,500</td>
<td>$30,000</td>
</tr>
</tbody>
</table>

*BUT LIMITED TO 25%/30,000 LIMIT.

2. **Design Alternatives.** The following plan design alternatives should be considered in light of the $150,000 compensation cap:

a. Simply add a money purchase pension plan alongside profit sharing plan or vice versa to reach $30,000 compensation level, but consider impact of contribution costs for NHCEs.

b. Target benefit plan.

c. Defined benefit plan.

d. Aged-based profit sharing plan.

e. Cross-tested plan.
f. 401(k) plan.

g. Limit coverage using 70% coverage rules; restrict eligibility.

h. Possibly exclude one or more HCEs to reduce 70% coverage requirement of NHCEs.

i. Integrate plan with social security.

j. Terminate plan.

k. SEP's (A Simple 401(k)).

l. Consider non-qualified deferred compensation.

II. ADMINISTRATION/OPERATIONAL ISSUES.

A. ERISA Section 404(c).

1. Why Consider ERISA Sec. 404(c) Compliance? Dr. Madison has taken great interest in making the investment decisions with respect to his participant directed account. However, he has read several articles lately suggesting that retirement plans with participant-directed accounts may not provide a sufficient source of retirement income. Although he is concerned about his retirement lifestyle, his more immediate concern is what he can do to limit any fiduciary liability with respect to the plan’s participant-directed investment options.

2. How Much Protection does ERISA Sec. 404(c) Provide? ERISA Section 404(c) provides that a plan fiduciary may be insulated from personal liability for losses to a participant’s account where the participant or beneficiary exercises independent control over the assets in his or her account. ERISA does not mandate that pension plans comply with Section 404(c). However, fiduciaries must understand that the protection is limited in scope, and only those plans who comply with the regulations will be afforded the protection of ERISA Sec. 404(c).

B. Missing Participants.

1. Plan Administrator’s Responsibility. Miss Link terminated employment with Dr. Madison five (5) years ago when she was 20% vested, and no one seems to know how to locate her. What is the Plan Administrator’s responsibility with respect to her $1,000 in plan assets?

2. DOL Requirements. In Department of Labor Opinion Letter 11-86, the Department concludes that steps a fiduciary must take to locate missing participants is a facts and circumstances determination.
3. **Compliance Suggestions:**

   a. Send notice to last known address.

   b. Search through company information, re: address of family, friends, relatives, etc.

   c. Use locator services such as IRS and Social Security Administration:

      (1) **IRS.** Rev. Proc. 94-22, 1994-9 I.R.B. 48, establishes procedures for locating individuals for "humane" purposes, which includes funds due from a company to an employee.

      (2) **Social Security Administration.** Search through local office involves use of participant's social security number or date of birth and/or names of the person’s parents.

   d. If still not located, read and comply with plan provision and then:

      (1) **PBGC Plan.**

         (a) Purchase irrevocable commitment (annuity from insurance co.), or

         (b) Transfer benefit to PBGC, or

         (c) Roll assets into a successor defined contribution plan.

      (2) **Ongoing Plan.**

         (a) Forfeiture of benefit and allocate to other participants, if unable to locate after reasonable time, but required reinstatement if later found.

         (b) Review State law regarding abandonment. See Va. Code Ann. Sec. 55-210.8 which provides that property is presumed abandoned unless contact/activity by owner within five (5) years of date distribution of part or all of the funds.
C. Distributions.

1. Beneficiary Designations.
   
   a. Marital Trust as Beneficiary. Dr. Madison wants to restrict Mrs. Madison's ability to direct the investment of his retirement plan assets after his death, and he also wants to make sure benefits pass to their children at Mrs. Madison's later death. What language is needed to qualify for marital deduction if beneficiary is a marital trust as well as to satisfy minimum distribution rules? See Exhibits A and B.
   
   b. Beneficiary Alternatives.
      
      (1) Spouse
      
      (2) Credit Shelter Trust
      
      (2) Charity

2. In-Service Distribution Rules. It is ten years later (2005), Dr. Jefferson, at age 40, continues to struggle with paying for his house on Monticello Lane. He has $200,000 in the corporation's money purchase pension plan, and $150,000 in the corporation's profit sharing plan. What funds are available to him from his retirement account assuming he can control plan design? Loans? In-service distributions? Plan termination? Does it make a difference if the corporation is a S corporation or a C corporation?

   a. Loans. Unlike a similar shareholder in a C corporation, loans are prohibited to an owner-employee of an S corporation. See I.R.C. Sec. 4975(d) and ERISA Sec. 408(d).

   b. "Owner-Employee" Defined. Any shareholder of an S corporation who owns, directly or indirectly, ten percent or more of the company's stock shall be defined as an "owner-employee."

   c. Profit Sharing Plans. Profit sharing plans, whether integrated or not, can be written to allow in-service withdrawals, but, of course, the 10% early withdrawal penalty under I.R.C. Sec. 72(t) applies. Rev. Rul. 71-446, 1971-2 C.B. 187, is apparently no longer operative to restrict withdrawal from integrated profit sharing plans.

   d. Penalty Exception for Periodic Payments. The periodic payment exception to the 10% tax (series of substantially equal period payments) is not available under I.R.C. Sec. 72(t)(2)(A)(iv) unless participant separates from service.
3. **Lump Sum Distributions & 5-Year Income Averaging.** Dr. Madison retires when he reaches age 55 (he was not age 50 before 1986), takes a total distribution from the money purchase pension plan and elected installments over his life expectancy and that of Mrs. Madison from the profit sharing plan. Can he elect lump sum treatment (i.e., 5 year averaging) with respect to distribution from the money purchase pension plan? **NO.** See *Middleton v. U.S.*, 93-1 USTC ¶50,150.

What if the money purchase pension plan is terminated, the assets rolled over into an IRA, and then a year later Dr. Madison takes a total distribution from the profit sharing plan. Isn’t he okay now? To quote the legislative history of I.R.C. Sec. 402(e)(4)(B), which reads:

"The House bill requires that a taxpayer who wishes to use the special averaging and capital gains treatment described above for one lump sum distribution must use that treatment for the aggregate of the lump sum distributions he receives in the same taxable year. The Senate amendment and existing law contain no comparable provision. The conference substitute and accepts the House Rule."

4. **I.R.C. Sec. 4980A Excess Distribution/Accumulation Tax.** Dr. Madison at age 55 realizes that due to his success in investing his retirement plan assets are now worth $750,000, with a projection that the $1,000,000 in assets will grow to at least $1,500,000 by age 65. Should I.R.C. Sec. 4980A impact his decision to continue to fund his retirement plan?

Although the impact of the 15% excise tax on excess distributions and the related 15% estate tax on excess accumulations should be considered as the size of a participant’s account balance increases, the effects of the tax can be minimized through distribution planning. Therefore, termination of the retirement plan is not necessarily the best and certainly not the only option in planning with respect to the excise tax under I.R.C. Sec. 4980A.

D. **Plan Administration Costs.** Dr. Madison wants the corporation to pay the commissions charged by the broker with respect to the sale of retirement plan stock. Can it do so without problems?

Patrick Henry, the broker, has said his "wrap fees" cover investment advice and sales commission expenses and that the corporation can now pay without problems. Is he correct? **NO.** See Ltr. Ruling 8452149 (September 17, 1984) and Rev. Rul. 86-142, 1986-2 C.B. 60, providing that brokerage fees cannot be paid separately and excluded from contributions. See Ltr. Rulings 8940013 (June 30, 1989) and 9005010 (November 2, 1989), wrap fees must be broken down by broker, with commission portion paid out of plan, and investment advice can be paid by Employer. See Ltr. Rul. 8941010 (June 30, 1989).
E. Plan Problems: Government Enforcement and Assistance.

1. **Trend Toward Increased Government Enforcement.** At a recent medical convention, several colleagues of Dr. Madison were describing the recent IRS audits of their qualified plans as an exhausting and expensive experience. In an effort to avoid a similar experience, Dr. Madison has his pension advisor review the operation of his retirement plan. During this review several potential problems were detected.

2. **IRS Examination Guidelines.** IRS Announcement 94-101, 1994-35 I.R.B. 53, issued August 12, 1994, contained final and proposed examination guidelines, as follows:
   a. Prohibited Transactions under I.R.C. Sec. 4975
   b. Valuation of Plan Assets
   c. Qualification Standards upon Plan Termination
   d. 401(k) Compliance
   e. 401(m) Compliance
   f. Plans Involving One or More Self-Employed Individuals (proposed)

3. **Administrative Policy Regarding Sanctions.**
   a. A permanent program officially implemented by the IRS March 26, 1991 in recognition of the fact that certain operational defects may be so minor that it is not productive for the IRS to pursue disqualification. Internal Revenue Manual at 7(10)54, Chapter 660.
   b. The program is administered at the IRS Key District Office level, and is applicable to a limited category of minor operational defects.

4. **Employee Plans Closing Agreements Program (CAP).**
   a. A program established December 21, 1990 by the IRS to allow plan sponsors to avoid plan disqualification for both form and operational plan defects, made permanent in late 1991. The program guidelines were formally amended by the IRS to provide for voluntary CAP procedures. Rev. Proc. 94-16, 1994-5 I.R.B. 22.
b. The plan sponsor must make full and complete correction of the errors and a non-deductible monetary sanction, negotiated between the plan sponsor and the IRS Key District Office, is paid in exchange for the preservation of the plan's continued qualified status.

c. A plan sponsor may enter CAP either while the plan is under examination by the IRS or on a voluntary "walk-in" basis, although the voluntary CAP program is not available for plans eligible for the VCR program. An anonymous "John Doe" inquiry may be made to the IRS by or on behalf of a plan sponsor.

5. Voluntary Compliance Resolution (VCR) Program.

a. A program initiated in late 1992 and administered by the IRS National Office to allow plan sponsors to correct, on a voluntary basis, certain operational plan defects. The IRS announced September 8, 1994 that the program was extended indefinitely, modified with respect to eligibility standards, and expanded with respect to the types of defects that may be corrected. Rev. Proc. 94-62.

b. The program is designed to allow a plan to correct operational defects only, and is not available if the plan is under examination by the IRS. A plan sponsor must pay a "user fee" to enter the program based on the plan's assets and the number of participants.

c. The Standardized VCR Procedure (SVP) is available for certain plan defects and allows the plan sponsor to correct the defect by following a pre-approved standardized correction procedure. Rev. Proc. 93-36, 1993-2 C.B. 474., Rev. Proc. 94-62. Standardized SVP corrections are available for the following problems:

(1) Failure to provide the minimum top-heavy benefit under I.R.C. Sec 416 to non-key employees.

(2) Failure to satisfy the non-discrimination tests for section 401(k) plans.

(3) Failure to distribute excess elective deferrals in excess of the maximum I.R.C. Sec. 402(g) limit.

(4) Exclusion of an eligible employee from plan participation.

(5) Failure to timely pay the minimum distribution required under I.R.C. Sec. 401(a)(9).
(6) Failure to obtain participant and/or spousal consent for distributions subject to spousal consent rules.

(7) Failure to satisfy the I.R.C. Sec. 415 rules in a defined contribution plan.

F. Qualified Plan Asset Protection.

1. The Facts. Dr. Madison’s retirement assets include:

- IRA $ 10,000
- Profit Sharing Account $ 75,000 (includes $20,000 of employee after tax voluntary contributions)
- 401(k) Plan funded with only deferred compensation $15,000
- Money Purchase Pension Account (FROZEN PLAN) $ 35,000
- Rollover IRA (from a keogh plan while working as a sole proprietor) $100,000
- Rollover IRA (from an incorporated plan while working at a group practice) $ 50,000
- Active Keogh Plan (from serving as a Board of Director Member on a publicly traded corporation that designs medical equipment) $ 5,000

He heard yesterday that Mrs. Madison forgot to mail in the malpractice premium check and their coverage has been canceled. Dr. Madison has previously performed 500 implants that pose a serious malpractice threat to his financial well being.
2. **The Issues.**

   a. Are Dr. Madison's retirement plan benefits excluded from the claims of creditors and the reach of bankruptcy?

   b. What if the IRS recently audited his plan and found that it had not covered Bill Hand and, therefore, the plan was disqualified? If the IRS has not audited his plan, but if the plan is possibly a disqualified plan due to coverage problem, what then?

   c. If one of the creditors is the IRS, are plan assets still protected? I.R.C. Sec. 6321 permits the IRS to file tax liens against pension plans.


   a. **The Wisdom (and Common Sense) of the Supreme Court.**

      (1) Section 541(c)(2) of the Bankruptcy Code excludes "a beneficial interest of the debtor in a trust" from the generally all-inclusive definition of property of the bankruptcy estate if the interest is subject to a "restriction on the transfer . . . that is enforceable under applicable non-bankruptcy law."

      (2) Section 541(c)(2) plainly applies to spendthrift trusts protected by state law, but the pension plan of Mr. Shumate's company did not qualify for that protection under Virginia law.

      (3) ERISA Sec. 206(d)(1) states: "Each pension plan shall provide that benefits provided under the plan may not be assigned or alienated."

      (4) The Supreme Court unanimously found that Section 541(c)(2) "plainly" encompasses any relevant law, not just state law, and that ERISA Sec. 206(d)(1) of "clearly" imposes a restriction on transfer that satisfies "the literal terms" of Section 541(c)(2).
The Court noted that this approach upheld the important ERISA policy of "uniform national treatment of pension benefits." Justice Scalia added this scathing comment:

"When the phrase "applicable non-bankruptcy law" is considered in isolation, the phenomenon that three Courts of Appeals could have thought it a synonym for "state law" is mystifying. When the phrase is considered together with the rest of the Bankruptcy Code (in which Congress chose to refer to state law as, logically enough, "state law"), the phenomenon calls into question whether our legal culture has so far departed from attention to text, or is so lacking in agreed-upon methodology for creating and interpreting text, that it any longer makes sense to talk of "a government of laws, not of men."

b. The Problem With the Supreme Court Decision. The Supreme Court's opinion initially states that the plan in question "satisfied all applicable requirements of [ERISA] and qualified for favorable tax treatment under the Internal Revenue Code." The Court did not state whether it was referring only to Title I of ERISA and did not mention that the tax provisions comprise Title II of ERISA. The Court's subsequent references simply refer to "ERISA-qualified plans," a phrase not commonly used by practitioners in this filed. Unfortunately, the Court never explained the meaning of "ERISA-qualified plan." This departure from "agreed-upon methodology," to use Justice Scalia's phrase, left the scope of the Court's decision unclear, allowing lower courts to limit its broad sweep.

c. Patterson Progeny.

(1) Requirement of ERISA Status and I.R.C. Tax Qualified Status.

(a) In re Hall, 151 B.R. 412 (Bankr. W.D. Mich. 1993), considered the bankruptcy of the president and sole shareholder of a company that sponsored "an individual retirement plan" for its hourly employees and a defined benefit plan covering the debtor and his wife, the corporate secretary. The court held that the pension plan that benefitted only the sole shareholder was not an "ERISA Plan" and therefore, the plan assets not protected in bankruptcy. The individual retirement plan, however, was exempt under the Bankruptcy Code.
(b) *In re Lane*, 149 B.R. 760 (Bankr. E.D. N.Y. 1993), considered the bankruptcy of a self-employed dentist who had maintained two Keogh plans in which he was the only participant, even though his dental practice had employees. The court held that these plans were not subject to ERISA because their only participant, the dentist, was not an "employee" within the meaning of ERISA and the applicable DOL regulation.

(c) *In re Witwer*, 148 B.R. 930 (Bankr. C.D. Calif., 1992), considered the bankruptcy of a doctor who was the sole shareholder and only employee of a corporation that sponsored a profit sharing plan. The court held that his plan was not subject to ERISA because the doctor was not an employee within the meaning of the ERISA and the DOL regulations. Further, the court reluctantly concluded that California law exempted the doctor's plan interest from the bankruptcy estate.

2 Requirement of ERISA Qualified Status Only. *In re Kaplan*, 162 B.R. 684 (Bankr. E.D. Pa. 1993), the court ignored the employee issue but required the plan's qualified status. Mr. Kaplan and Mr. Becker were the only partners in a stock options trading business that sponsored a defined benefit plan. They subsequently formed an S corporation that assumed sponsorship of the plan. At some point, Mr. Kaplan bought out Mr. Becker, who withdrew his plan interest in 1989. Neither the partnership nor the corporation had any other employees and no one else ever participated in the plan. In 1993, Mr. Kaplan filed for bankruptcy and argued that his plan interest was excluded from the bankruptcy estate. The court held that the plan was not ERISA-qualified and thus *Patterson* did not apply to exclude plan assets from the bankruptcy estate.

3 Cases That Generally Follow Patterson.

(a) *In re Carey*, 150 B.R. 196 (Bankr. N.D. Ohio, 1992), trustee conceded that the 401(k) plan account of Merrill Lynch account executor was excluded.

(b) *In re Ziegler*, 156 B.R. 151 (Bankr. W.D. Pa., 1993), held that a disabled participant, who was still employed, lacked access to his plan account.
(c) **In re Dunham**, 147 B.R. 13 (Bankr. E.D. N.C., 1992), held that termination of employment with the plan sponsor did not give the debtor sufficient discretion over the plan document.

(4) **Virginia Case Reinforces Patterson.** In re Hanes, 162 B.R. 733 (Bankr. E.D. Va., 1994), rejected Hall's conclusion that a plan must comply with the Tax Code, concluding that Patterson's references to I.R.C. Sec. 401(a)(13) simply reinforced the need for the plan to be subject to ERISA and to have an anti-alienation provision to be protected by Section 541(c)(2).

(5) **Aggressive Planning in Light of Patterson.** Finally, In re Shailam, 144 BR 626 (Bankr. N.D. N.Y., 1992) is a marked contract to the cases distinguishing Patterson. Dr. Shailam practiced medicine through a wholly owned corporation that sponsored a defined benefit plan; Dr. Shailam, his wife, and one other employee were the only participants. The 1987 stock market crash virtually wiped out the plan's assets, and for the next four years, the corporation put "all of its available income" after expenses into the plan. Dr. Shailam personally filed for bankruptcy and claimed exemptions for his plan interest and an interest in a Keogh plan established before incorporation of his practice.

The Court held that both plans were excluded from the estate and rejected the argument that the plans' funding was a fraudulent conveyance under New York law. It also held that although Dr. Shailam's conduct of the plan before 1987 violated ERISA fiduciary duties, he was then "under a federal mandate" to restore the plan's funding. The Court concluded:

"The fact that this is a closely-held Corporation should not compel a different conclusion in applying the provisions of ERISA . . . The result reached here would clearly not be questioned if the pension plan involved had numerous participants. However, the result should be the same regardless of the number of participants."

(6) **Impact of Plan's Qualified Status & IRA Rollovers.** The determination by the IRS as to the plan's qualified status is determinative with respect to the bankruptcy estate exemption and its applicability to IRA rollover proceeds. Re Youngblood (1994, CA5). See also Stochastic Decisions, Inc., v. Wagner (1994, CA2). In Wagner,
Arthur Wagner established a profit sharing keogh in the 1970s and from 1986 to 1990 improperly treated his wife as an employee. A creditor under New York law was able to go after $200,000+ in plan assets that had been temporarily rolled into an IRA and then apparently back into a retirement plan, the Court holding for creditor that the plan was disqualified. See also Re Cesare (1994, BC DC CT) where rollover from qualified plan was not afforded bankruptcy protection.


   "B. The interest of an individual under a retirement plan shall be exempt from creditor process to the extent provided under this section. The exemption provided by this section shall be available whether such individual has an interest in the retirement plan as a participant, beneficiary, contingent annuitant, alternate payee, or otherwise.

   C. The exemption provided under subsection B shall not apply to the extent that the interest of the individual in the retirement plan would provide an annual benefit in excess of $17,500. If an individual has an interest in more than one retirement plan, the limitation of this subsection C shall be applied as if all such retirement plans constituted a single plan."

   The amount required to provide an annual benefit of $17,500 is determined under a table provided in the Code. For example, the amount required to provide an annual benefit of $17,500 to an individual who attained age 60 at the time the exemption provided by this section is $89,512.50 ($17,500 times 5.1150).

   b. ERISA Preemption. In Schlein v. Mills, 8 F.3d 745 (11th Cir. 1993), the Eleventh Circuit joined the Fifth and Eighth Circuits in holding that ERISA does not preempt state law exemptions. In Schlein, the court explicitly agreed with the reasoning in In re Dyke, 943 F.2d 1435 (5th Cir. 1991) and In re Vickers, 954 F.2d 1426 (8th Cir. 1992).
G. Qualified Plan Investments and FDIC Insurance.

1. Fiduciary Considerations. When investing the retirement plan assets in federally insured deposits with banks, what should Dr. Madison do to maximize his FDIC coverage? He understands certain marginal banks or savings and loans offer higher interest rates to attract deposits, but he also understands as the plan fiduciary he could be personally liable for plan losses from lack of FDIC coverage.


a. The Law. The FDIC Improvement Act of 1991 provides that each participant will potentially have up to $100,000 of coverage at each institution in which the plan maintains a qualifying account.

b. Planning Considerations.

(1) Confirm that the institution is federally insured.

(2) Confirm that the bank can currently accept "brokered deposits" (to qualify the bank must be listed in Prompt Corrective Action Category Status with FDIC), or receive written notice from the bank that deposits will qualify for pass through coverage despite no FDIC approval of bank to accept brokered deposits.

(3) Confirm status for renewals and rollovers, as well as new accounts.

(4) Do not use a marginal bank for accounts where funds are added or withdrawn frequently to avoid confirming status at each transaction.

(5) A "grandfathered account" is protected up to $100,000 even if the bank later fails to qualify under the broker deposit rule.

(6) Participants have protection on only their vested balance; all non-vested funds of the corporate plan are aggregated subject to $100,000 maximum coverage.

(7) All employee benefit accounts at a simple financial institution are aggregated for the $100,000 limit. All IRA, self-directed, keogh accounts, self-directed qualified retirement plan accounts, and Section 457 plans of a participant at the same bank are aggregated for the $100,000 limit.
III. PLAN TERMINATION.

A. Funding Obligations.

1. Profit Sharing Plans. It is December 22 and Dr. Madison would like to terminate the Company's profit sharing retirement plan. If some of his employees have worked >1000 hours, can he terminate the plan without having to make a contribution to it?

2. Money Purchase Pension Plans. If instead the plan was a money purchase pension plan, could he terminate it on December 22 without having to make a contribution? Would it make a difference if the corporation had more than 25 participants or was a commercial enterprise instead of a professional service corporation?

B. Notice Requirements.

1. General Rule. ERISA Sec. 204(h) provides that defined benefit plans, money purchase pension plans, and target benefit plans must give not less than 15 days notice before effective date of termination to each participant and beneficiary. This rule is not applicable, however, to a plan not covered by Title IV of ERISA; for example, plans of professional service corporations with less than 25 active participants are not subject to Title IV.

2. Exceptions. Profit sharing plans and defined benefit plans of professional service corporations (under 25 participants) even if a defined benefit plan, target benefit plan, or money purchase pension plan need not give the 15 day notice to participants, but formal Board of Directors' action is required. See ERISA Sec. 4021(a) and (b).

IV. RECENT DEVELOPMENTS.

A. Fiduciary Responsibility & Guaranteed Fund Accounts.

1. The Supreme Court Rules. The Supreme Court ruled that an insurer is a fiduciary when it issues a group annuity policy or a deposit administration contract that provides a rate of return based on the investment return on the insurance company's general account. *John Hancock Mut. Life Ins. Co. v. Harris Trust & Sav. Bank*, 114 S. Ct. 517 (Dec. 1993).
2. **The Insurance Industry's Response.** In response to the John Hancock decision, on March 25, 1993 the American Council of Life Insurance filed a request for a Labor Department class exemption from the prohibited transaction provisions of ERISA for unconditional, retroactive relief.

B. **Clarification of Plan Amendment Procedures.** The Third Circuit struck down a plan amendment and held that a plan sponsor's reservation of the right to amend an employee benefit plan is not the same as specifying a procedure for amending the plan, as required by ERISA 402(b)(3). *Schoonejongen v. Curtiss-Wright Corp.*, 18 F.3d 1034 (3d Cir. 1994). However, the U.S. Supreme Court announced September 26, 1994 that it would review the Third Circuit's decision. *Schoonejongen v. Curtiss-Wright Corp.*, US SupCt, No. 93-1935, 9/26/94.


D. **Final Withholding Regulations.**

1. **New Rules as of January 1, 1994.** The Internal Revenue Service issued final regulations relating to the reporting and depositing of Federal employment taxes, applicable to all distributions from qualified plans on or after January 1, 1994 from which income taxes are withheld.

2. **New Tax Form and Filing Requirements.** In lieu of filing Form 941 on a quarterly basis, non-payroll withholding amounts on pension distributions must be reported to the IRS on an annual basis on new Form 945. For 1994, Form 945 must be filed with the Internal Revenue Service by January 31, 1995. However, if all deposits for the year were paid in full and timely, the return may be filed by February 10, 1995.

E. **Individual Retirement Accounts.**

1. **Investment in Personal Residence Disqualifies IRA.** The use of assets in an IRA account for the purchase of a personal residence was a prohibited transaction which disqualified the IRA and resulted in a distribution subject to income tax and the ten percent additional tax under I.R.C. Sec 72(t). *Harris, TC Memo 1994-22.*

2. **Tax Lien on IRA Enforceable in Bankruptcy.** An IRS tax lien attached to a taxpayers's rights in his IRA despite the anti-alienation clause. *In re Schreiber* (Bankr N.D. Ill. 1994).

want to continue SEP sponsorship must adopt a new form by March 31, 1995, and distribute a copy of the adopted form to eligible employees.

G. **Form 5500. Schedule G Reporting Delayed.** The Department of Labor delayed indefinitely the "mandatory" Schedule G filing for plan years beginning after 1993. However, the information required by Schedule G still must be included as part of the Form 5500 filing (59 FR 25672). Completion of Schedule G was optional for 1992 and 1993 plan years.


I. **Regulations Finalized.**

1. **$150,000 Annual Compensation Limitation.** Final regulations were issued under I.R.C. Sec. 401(a)(17), replacing the proposed regulations issued December 30, 1993 with only minor modifications. (TD 8647, 6/23/94)

2. **Separate Lines of Business.** Final regulations were issued with respect to application of the SLOB rules for purposes of I.R.C. Secs. 401(a)(26) and 410(b), with only slight modifications to the proposed regulations issued September, 1993. (TD 8548, 6/23/94)

J. **QDRO Administrative Costs.** The Department of Labor has issued an advisory opinion prohibiting a plan sponsor from charging the administrative costs of the qualified domestic relations order (QDRO) against the account of the affected participant. The DOL ruled that the statutory duties in administering QDRO's imposed by ERISA was on the plan administrator. ERISA Op. Letter No. 94-32A.

K. **SPD Misrepresentation.**

1. **Employer Liability.** The employer, rather than the insurer, was liable for payment of supplemental accidental death and dismemberment benefits as a result of a misrepresentation of benefit coverage in the plan's Summary Plan Description. Curcio v. John Hancock Mutual Life Ins. Co., (1994, CA3). This case has significance not only for ERISA welfare plans but for qualified retirement plans as well.

979 F.2d 23 (4th Cir. 1992). However, a 1994 decision has held that the employee cannot recover from the employer on the basis of SPD misrepresentations where no reliance or prejudice is shown. *Stiltn v. Beretta U.S.A. Corp.*, 844 F. Supp. 242 (D. Md. 1994).

**L. 1994 Deduction Limits for Keogh Contributions.** The IRS Audit Guidelines provide guidance on how to compute the limit on deductible contributions by a self employed individual to a qualified retirement plan and illustrate the computations required taking into account the individual's net self employment income, the self-employment tax, and the annual limit on compensation. Ann. 94-101. Under the bill, service members could be deemed perform military service for up to five years and would be entitled to the same rights and benefits available to other employees on leave of absence. Ann. 94-101.

**M. Uniformed Services Employment and Reemployment Rights Act of 1994.** President Clinton signed the Uniformed Services Employment and Reemployment Rights Act of 1994 on October 13, 1994, guaranteeing protection of benefits to non-career military service members called to military duty. Service members will be able to perform military service for up to five years and continue to be entitled to the same rights and benefits available to other employees on leave of absence. An employer's health plan must offer continued coverage for up to 18 months to individuals on leave for military service.

**N. GATT and Pension Reform (without Cross-Testing).** Provisions from the Retirement Protection Act of 1993 (PBGC reform bill) have been included in General Agreement on Tariffs and Trade (GATT) legislation, as a means to help offset revenue losses from the reduction in tariffs in the trade bill. The PBGC provisions prohibiting cross-testing for defined contribution plans, which was sought by the Treasury Department to prevent employers from providing higher pre-tax benefits to highly compensated employees, has been eliminated from the legislation. (21 *BPR* 1804). Since the GATT legislation is on a fast track, the proposed pension reforms cannot be further amended. The Senate plans to consider the legislation December 1-2.

Major pension reform provisions in the GATT legislation include: PBGC reforms, rounding rules for pension cost-of-living adjustments, extension of authority for employers to use excess pension funds to pay for retirees' health benefits, and extension of IRS user fees.

**O. TRA '86 Remedial Amendment Period.** The Remedial Amendment Period for the Tax Reform Act of 1986 ends for calendar year plans on December 31, 1994. For fiscal year plans, the remedial amendment period ends on the last day of the 1994-95 plan year (e.g., September 30, 1995 for a September 30 plan year). Notice 92-36, 1992-35 I.R.B. 12. (Plans of tax-exempt or governmental organizations have until the end of the 1996 plan year to amend their plans for the Tax Reform Act of 1986.)
EXHIBIT A

QUALIFIED RETIREMENT PLAN BENEFICIARY DESIGNATION

FOR MARITAL DEDUCTION TRUST

Plan: ________________________________

Participant: __________________________

Identification of Beneficiaries

Pursuant to the above plan, I hereby designate the following beneficiaries as beneficiaries of my accrued benefit (or account balance) under the plan payable by reason of my death:

1. **Primary Beneficiary.** If my spouse, _______________, survives me, the beneficiary shall be the ________________ Trust, dated ________________, to be allocated and distributed thereunder, the governing provisions of such Trust, as amended, being hereby incorporated by reference as may be necessary for such purpose.

2. **Secondary Beneficiary.** If ________________ does not survive me, the beneficiary shall be the ________________ Trust, dated ________________.

Distribution

The method of distribution shall be as follows:

A. For the portion allocated to the Marital Trust as follows:

   The income earned on the undistributed balance of the account during the calendar year shall be paid annually to the Marital Trust by the close of the calendar year; further, the principal balance of the account shall be distributed in equal annual installments over the life expectancy of my spouse to the Marital Trust; and on my spouse’s death the remaining account balance shall be distributed to the Marital Trust. Nothing herein shall prevent the Trustee from distributing a greater amount from the account to the Marital Trust. This portion is intended to qualify for the marital deduction, and this beneficiary designation shall be interpreted in that regard, and the Trustee of the Marital Trust shall be permitted to withdraw such additional amounts as are required to comply therewith.
EXHIBIT A (continued)

B. For any portions going to a trust other than to the Marital Trust as follows, as the Trustee selects. For any portions going outright to a beneficiary, as that beneficiary selects.

This beneficiary designation and method of distribution is irrevocable as to the Trustee or other beneficiaries, and cannot be changed by them. If a method of distribution selected above is not permitted under the governing plan or agreement in existence at my death, then a lump sum distribution shall be made in lieu of the method of distribution selected.

I reserve the right to revoke or change any beneficiary designation. I hereby revoke all prior beneficiary designations (if any). If I become divorced from my spouse named above, the primary beneficiary designation is revoked and the secondary beneficiary designation shall become the primary beneficiary designation.

Marital Status of Participant

Under full penalties of State and Federal Law, I do swear:

I am married, and my spouse’s name is ______________. I also understand that if I am both divorced from my present spouse and am remarried to another person, this beneficiary designation is automatically revoked, unless I designate another beneficiary with the written consent of my spouse at such time.

I hereby agree to notify the Plan Administrator or Advisory Committee of any change in my marital status while I am a participant in the plan.

Waiver of Pre-Retirement Survivor Annuity

In accordance with Federal Law, I elect NOT to have my Nonforfeitable Accrued Benefit paid in the form of a Pre-Retirement Survivor Annuity if payment of my benefit (or account balance) has not commenced at the time of my death. The Plan Administrator has furnished me an explanation of the terms of the Pre-Retirement Survivor Annuity, my right to make this waiver election, the time period during which I may make this waiver election, and the financial effect of my election not to have my benefits paid in the Pre-Retirement Survivor Annuity form. I understand I may revoke this election at any time during the election period explained to me by the Plan Administrator. I further understand by making this election, the Plan Administrator will determine the form in which the Trustee will distribute my nonforfeitable accrued benefit to my Beneficiary.

CAUTION: If you signed a special "242(b)" designation form in 1983, signing this form will revoke that one and, as a result, you may lose valuable tax benefits.

I have executed this Beneficiary Designation on ______________.

______________________________
Participant
CONSENT OF SPOUSE

I, the undersigned, spouse of the Participant named in the foregoing "Designation of Beneficiary," hereby certify I have read the Designation of Beneficiary and fully understand the property subject to the designation includes property in which I otherwise would possess a beneficial interest of not less than fifty percent (50%) of my spouse's accrued benefit (or account balance) under the Plan, provided I survive my spouse. Being fully satisfied with the provisions of the designation, I hereby consent to and accept the beneficiary designation and the waiver of the Pre-Retirement Survivor Annuity, without regard to whether I survive or predecease my spouse. I certify that I understand the terms of the Pre-Retirement Survivor Annuity explained in the plan and in a memorandum furnished by the Plan Administrator, my right not to consent to this waiver election, the time period during which my spouse and I may make this waiver election, and the financial effect of the election not to receive benefits in the Pre-Retirement Survivor Annuity form.

This Consent is irrevocable unless my spouse changes the beneficiary designation. If my spouse changes the designation, or if the beneficiary designation is to a trust and my spouse changes the provisions of that trust to materially affect how this property passes on my spouse's death, I must file a similar consent to the new beneficiary designation (or amended trust, as applicable), or my consent is no longer effective.

I have executed this Consent on ________________.

____________________________________________
Participant’s Spouse

COMMONWEALTH OF VIRGINIA,
CITY/COUNTY OF _______________________, to-wit:

Before me, the undersigned, a Notary Public, personally appeared _______________________, who executed the above Consent of Spouse as a free and voluntary act.

IN WITNESS WHEREOF, I have signed my name and affixed my official notarial seal on ________________.

My commission expires: ________________________.

____________________________________________
Notary Public
EXHIBIT B

Sample Marital Trust Agreement Language Regarding Retirement Payments:

Retirement Payments. My Trustee shall ensure that my spouse receives each year all the net income produced by any individual retirement account (IRA) or other retirement or deferred income arrangement of which my Trustee is the designated recipient. To that end, I direct my Trustee to exercise the powers my Trustee holds as recipient of my retirement benefits to receive no less than the amount of net income produced each year. In managing the Marital Trust, my Trustee shall allocate to income the portion of the payments that represents net income, as determined for marital deduction qualification purposes, of the IRA or other such arrangement. My Trustee shall allocate the rest of the payments to principal.
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