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Employee Benefits Up-Date: Coping with Chaos

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EMPLOYEE BENEFITS UP-DATE: COPING WITH CHAOS
by
Mark S. Dray

I. TRA '86 COMPLIANCE: CHAOS OR WHAT'S A PLAN SPONSOR TO DO?

A. INTRODUCTION.

For the most part, qualified plan changes mandated by the Tax Reform Act of 1986 (TRA '86), Pub. L. No. 99-514 (October 22, 1986), were to have been adopted by the last day of the plan year beginning in 1989. This deadline has been extended several times. In the meantime, plans must be operated in accordance with the new rules, as of their required effective dates, even though plan sponsors now have until the end of plan years beginning in 1994 to actually bring their qualified plans into compliance with the new requirements.

1. Special rules apply to collective bargaining plans.

2. Generally, single-employers have been able to make changes to their non-collectively bargained single-employer plans through the filing dates of their tax returns (including extensions) for the year in question. For example, if a plan and an employer were both on a calendar year, amendments required to be effective January 1, 1989, could usually have been made on or before September 15, 1990. In light of the fact that this traditional "remedial amendment period" date has already been extended well beyond the otherwise applicable required amendment date, at this juncture, plans will have to be amended (and preferably filed with the Internal Revenue Service (the Service) for new determination letters) by the last day of their 1994 plan years.

   a. Amendments will, of course, have to be retroactively effective.

3. The plan administration, compliance and potential legal problems created by this process under Title I of ERISA are significant.

B. THE CHRONOLOGY OF EVENTS.

1. Tax Reform Act of 1986. TRA '86 was enacted October 22, 1986. It generally provided that amendments to qualified plans to comply with the new rules need not be made until the last day of the first plan year beginning on or after January 1, 1989.

   2. Notice 86-13, 1986-2 C.B. 377 (11-17-86). This notice outlined the retroactive changes in the law enacted by TRA '86 and the impact of post TRA '86 determination letters pending promulgation of regulations or other guidance under the new rules.

   3. Notice 87-13, 1987-1 C.B. 432 (1-26-87). This notice provided guidance on several fronts pending the issuance of
regulations including: (i) the annual limitations on elective deferrals under § 401(k) plans (§ 402(g)); (ii) the new § 72 rules pertaining to the taxation of employee contributions; (iii) the partial distribution rollover rules; (iv) the 50 percent estate tax deduction applicable to certain sales of employer securities to ESOPs (§ 2057); (v) certain transition rules applicable to pre-March 16, 1987, lump sum distributions; and (vi) the extension of § 457 to tax-exempt organizations.

4. Notice 87-21, 1987-1 C.B. 458 (2-9-87). This notice provided a series of questions and answers dealing with TRA '86's new § 415 limitations.

a. The ten year phase in rules under § 415(b)(5)(D) were modified by Notice 89-45, 1989-1 C.B. 684.


6. Notice 87-33, 1987-33 (5-4-87). This notice provided model amendments that could be adopted by sponsors of master and prototype plans with respect to TRA '86 provisions that were effective for plan years beginning before January 1, 1989.

7. Notice 87-34, 1987-1 C.B. 490 (5-4-87). This notice provided a model amendment that could be used by sponsors of master or prototype plans to incorporate a cash or deferred arrangement (CODA).

a. This notice was subsequently amended to add certain optional amendments relating to hardship distributions and matching contributions. Notice 87-51, 1987-1 C.B. 359.

8. Notice 87-57, 1987-2 C.B. 368 (8-31-87). This notice put plan sponsors on notice that terminating plans needed to be amended to comply with TRA '86 changes in effect at the time of a plan's termination so as not to adversely affect its prior qualification.

9. Temporary Regulations under §§ 410 and 411, TD 8170, 53 FR 238 (1-6-88). These temporary regulations provide guidance needed to comply with the new minimum vesting standards.

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1 All references indicated by "§" (the symbol for section) are to the Internal Revenue Code of 1986, as amended; references to "ERISA" or indicated by "ERISA §" are to the Employee Retirement Income Security Act of 1974, as amended.
The temporary regulations were generally effective for plan years beginning after December 31, 1988.

   a. Not only do plan sponsors need new determination letters but they have to be paid for!
   b. This procedure was modified by Rev. Proc. 90-17, 1990-1 C.B. 479.


12. Temporary Regulations Under §§ 414(g) and 414(s), TD 8173, 53 FR 4965 (2-19-88). These temporary regulations relate to the scope and meaning of the terms "highly compensated employee" in § 414(g) and "compensation" in § 414(s). Generally, the regulations apply to plan years beginning on or after January 1, 1987.
   a. These temporary regulations were modified by new temporary regulations issued 5-14-90 (55 FR 19875).

13. Notice 88-33, 1988-1 C.B. 513 (3-28-88). This notice explained the procedures for returning excess deferrals under § 402(g), excess contributions under § 401(k) and excess aggregate contributions under § 401(m).
   a. This notice was modified by Notice 89-32, 1989-1 C.B. 671.

14. Notice 88-56, 1988-1 C.B. 540 (5-9-88). This notice provided guidance concerning the new ESOP diversification requirements under § 401(a)(28) and the new rules governing the taxation of distributions under § 72.

15. Proposed Regulations Under § 401(l), 53 FR 45917 (11-15-88). These proposed regulations relate to permitted disparity in employer contributions and employer-derived benefits under qualified plans, and are generally effective for plan years beginning after December 31, 1988.
   a. The proposed regulations were modified by Notice 89-70, 1989-1 C.B. 730; proposed regulations issued 5-14-90 (55 FR 19947); and the final regulations promulgated 9-19-91 (56 FR 47610).

17. Notice 88-131, 1988-2 C.B. 546 (12-27-88). This notice provided relief to plan sponsors that was intended to allow them time to consider and comply with the new rules without violating the anti-cutback rules under § 411(d)(6). The notice provided several alternatives and Model Amendments that a plan sponsor could adopt, including:

   a. Model Amendment 1 - § 401(a)(17) Compensation Limit Only. This approach made sense where changes in a plan's benefit or allocation formula were not contemplated or employers were willing to increase benefits for non-highly compensated employees to prevent discrimination.

   b. Model Amendment 2 - Cessation of Benefit Accruals for Highly Compensated Employees Only.

   c. Model Amendment 3 - Cessation of Benefit Accruals for All Participants.

   d. Alternative II-D. This procedure basically allowed a plan to continue to operate for non-highly compensated employees pending TRA '86 compliance.

      (1) Highly compensated employees could not receive a distribution after January 31, 1989, exceeding their accrued benefit as of the last day of the 1988 plan year until the plan was amended to comply with TRA '86.

      (2) Non-highly compensated employees would be entitled to a benefit equal to the greater of the benefit under the old plan formula or the new plan formula for 1989 after the plan was amended for TRA '86 compliance.

   e. Such amendments could be adopted without giving participants an ERISA § 204(h) notice. Although this didn't create "qualification issues," it could well have created ERISA Title I problems.


18. Notice 89-8, 1989-1 C.B. 628 (1-17-89). This notice basically extended the end of a plan's remedial amendment period to the later of the filing date of the employer's tax return for the fiscal year in which the 1989 plan year began or the last day of the 1989 plan year.

19. Rev. Proc. 89-9, 1989-1 C.B. 780 (2-6-89). This procedure outlined the rules pertaining to the issuance of opinion letters relating to certain master and prototype plans.

20. Rev. Proc. 89-13, 1989-1 C.B. 801 (2-13-89). This procedure provided the procedures for issuing notification letters regarding the qualification, as to form, of certain
regional prototypes, and provided guidance regarding the issuance of determination letters thereon to adopting employers.

21. Proposed Regulations Under § 401(a)(26), 54 FR 6710 (2-14-89). These proposed regulations relate to the minimum participation requirements under § 401(a)(26) and were generally effective for plan years beginning on or after January 1, 1989.

   a. These regulations were withdrawn on 5-14-90 and new proposed regulations were issued (55 FR 19935).

22. Notice 89-23, 1989-1 C.B. 654 (12-21-89). This notice provided safe harbors and other rules to allow tax sheltered annuities to comply with the new non-discrimination rules.


24. Proposed Regulations Under § 410(b), 54 FR 21437 (5-18-89). These proposed regulations relate to the minimum coverage requirements of § 410(b), and were generally effective for plan years beginning on or after January 1, 1989.

   a. These regulations were supplemented and modified by proposed regulations issued on 5-14-90 (55 FR 19897), further modified on 9-14-90 (55 FR 37888), 12-3-90 (55 FR 49906), 2-1-91 (56 FR 3988) and issued in final form on 9-19-91 (56 FR 47638).


31. **Announcement 90-48, 1990-15 IRB 37 (4-4-90)**. Extended deadlines for master or prototype and regional prototype plans.

32. **Proposed Regulations Under § 401(a)(26), 55 FR 19935 (5-14-90)**. The regulations proposed on February 14, 1989 (54 FR 6710) are withdrawn and new regulations proposed.
   
   a. The regulations are further modified on 2-1-91 (56 FR 3988).

33. **Proposed Regulations Under § 401(a)(17), 55 FR 19947 (5-14-90)**. These proposed regulations relate to the $200,000 compensation limit under § 401(a)(17) and are generally effective for plan years beginning on or after January 1, 1991. The document also contains amendments to previously proposed regulations under §§ 401(k), 401(l), 401(m) and 410(b).

34. **Proposed Regulations Under §§ 401(a)(4) and 410(b), 55 FR 19897 (5-14-90)**. These proposed regulations address the $401(a)(4) requirement that contributions or benefits provided under a qualified retirement plan not discriminate in favor of highly compensated employees and the related § 410(b) requirements, and are generally effective for plan years beginning after December 31, 1991.
   
   a. The regulations are further modified on 9-14-90 (55 FR 37888), 12-3-90 (55 FR 49906), 2-1-91 (56 FR 3988) and are issued in final form on 9-19-91 (56 FR 47638 and 47524).

35. **Temporary Regulations Under § 414(s), 55 FR 19875 (5-14-90)**. These proposed regulations relate to the scope and meaning of the term "compensation" under § 414(s) and are generally effective for plan years beginning on or after January 1, 1987.
   
   a. The regulations modify prior regulations issued 2-19-88 (53 FR 4965) and are issued in final form on 9-19-91 (56 FR 47565).


37. **Proposed Regulations Under §§ 401(a)(4) and 410(b), 55 FR 37888, 37901 (9-14-90)**. This document contains amendments to two sets of previously proposed regulations:

   a. The amendments to the first set revise and amplify certain nondiscrimination rules under § 401(a)(4), originally published on May 14, 1990 (55 FR 19897), as well as revising the proposed regulations under § 401(l). Originally issued 11-15-88 (53 FR 45917) and modified on 5-14-90 (55 FR 19947).

   b. The amendments to the second set change the rules governing the application of the average benefit test.
under § 410(b) to ESOPs. The regulations supplement and modify the regulations issued 5-18-89 (54 FR 21437) and modified on 5-14-90 (55 FR 19897 and 55 FR 19947).

38. Proposed Regulations Under §§ 401(a)(4) and 410(b), 55 FR 49906 (12-3-90). This document amends previously proposed regulations under §§ 401(a)(4) and 410(b) to delay the effective dates in the proposed regulations to plan years beginning on or after January 1, 1992.

   a. The regulations revise the regulations issued on 5-14-90 (55 FR 19897) and modified on 9-14-90 (55 FR 49906).


   a. This notice extends the ability to suspend benefit accruals under Model Amendment 3 of Notice 88-131, beyond the last day of the 1990 plan year only if a so-called ERISA § 204(h) notice was provided.

   b. The relief available under Alternative II D of Notice 88-131 was scheduled to expire at the end of the plan year beginning in 1991.

   c. The safe harbors under § 403(b)(12) (relating to tax sheltered annuities), which had been extended to the end of 1990 under Notice 89-23, were extended indefinitely until the Service provided additional guidance.

40. Proposed Regulations Under §§ 414(r), 410(b)(5) and 401(a)(26)(G), 56 FR 3988 (2-1-91). This document contains proposed regulations under §§ 414(r), 410(b)(5) and 401(a)(26)(G). The regulations provide the exclusive rules for determining whether an employer operates qualified separate lines of business under § 414(r) for purposes of applying the minimum coverage requirements of § 410(b) and the minimum participation requirements of § 401(a)(26).

41. Temporary Regulations Under §§ 414(q) and 414(r), TD 8334, 56 FR 3976 (2-1-91). This temporary regulation clarifies the amended definition of "highly compensated employee" under § 414(q) in applying the separate line of business rules under § 414(r). The regulations are generally effective for plan years beginning on or after January 1, 1987.


   a. This procedure was modified or superseded by the temporary procedures announced in Rev. Proc. 91-66, 1991-2 C.B. 870.
43. **Final Regulations Under §§ 401(k) and (m), TD 8357, 56 FR 40507 (8-15-91).** These regulations represent the final regulations relating to certain CODAs and employee after-tax and employer matching contributions under qualified plans. The regulations are subsequently corrected in the March 25, 1992 Federal Register.

   a. The final regulations were further amended by the final regulations under § 414(r) issued on 12-4-91 (56 FR 63420).


45. **Notice 91-38, 1991-2 CB 636 (11-18-91).** This notice extended Alternative II D (Notice 88-131) to the last day of 1992 plan years and established several transition rules applicable to the final § 401(a)(4) regulations and the soon to be issued separate line of business or SLOB regulations.

   a. Although the notice indicated the regulations were to be effective for plan years beginning on or after January 1, 1992, considerable flexibility is to be given plan sponsors to allow design decisions to be made during the year.

46. **Final Regulations Under § 401(l), TD 8359, 56 FR 47610 (9-19-91).** These are the final regulations relating to permitted disparity in employer contributions to, and employer-derived benefits under, qualified plans and are generally effective for plan years beginning after December 31, 1988.

47. **Final Regulations Under § 401(a)(4), TD 8360, 56 FR 47524 (9-19-91).** These final regulations interpret the § 401(a)(4) requirements that contribution or benefits provided under a qualified Plan not discriminate in favor of highly compensated employees and are generally effective for plan years beginning after December 31, 1991.

48. **Final Regulations Under § 414(s), TD 8361, 56 FR 47659 (9-19-91).** These final regulations address the scope and meaning of the term "compensation" under § 414(s) and were generally effective for plan years beginning on or after January 1, 1987.

49. **Final Regulations Under § 401(a)(17), TD 8362, 56 FR 47603 (9-19-91).** These final regulations address the $200,000 compensation limit under § 401(a)(17) and were generally effective for plan years beginning on or after January 1, 1991.

50. **Final Regulations Under § 410(b), TD 8363, 56 FR 47638 (9-19-91).** These final regulations relate to the minimum coverage requirements under § 410(b) and were generally effective for plan years beginning on or after January 1, 1991.
51. **Announcement 91-171, 1991 IRB 30 (11-18-91).** This announcement provided determination letter applicants guidance on how to submit information to demonstrate compliance with the new coverage and minimum participation rules under §§ 410(b) and 401(a)(26).

52. **Final Regulations Under § 401(a)(26), TD 8375, 56 FR 63410 (12-4-91).** These final regulations relate to the minimum participation requirements under § 401(a)(26) and are generally effective for plan years beginning on or after January 1, 1989.

53. **Final Regulations Under § 414(r), TD 8376, 56 FR 63420 (12-4-91).** These final regulations under § 414(r) provide the exclusive rules for determining whether an employer operates qualified separate lines of business for purposes of applying the minimum coverage requirements of 410(b) and the minimum participation requirements of § 401(a)(26). They also contain related amendments to regulations under §§ 401(k) and (m) and 410(b).

54. **Rev. Proc. 91-64, 1991-2 C.B. 866 (12-16-91).** This procedure announced the industry categories and Standard Industrial Classification ("SIC") codes within each that would apply for purposes of the separate line of business ("SLOB") regulations. Treas. Reg. § 1.414(r)-5(c)(3).

55. **Announcement 92-29, 1992-9 IRB 37 (3-2-92).** This announcement generally extended effective dates for the new nondiscrimination regulations to the first day of plan years beginning on or after January 1, 1993. For exempt organizations (including governmental plans) the effective date was extended to the first day of the plan year beginning on or after 1995.

   a. For plan years before these dates the announcement also extended the "reasonable good faith reliance period."

   b. The remedial amendment period under § 401(b) was extended through the last day of the plan year beginning on or after 1993.

   c. The relief provisions of Notice 91-38 (including the extension of reliance on Alternative II-D) were also extended through the last day of the first plan year beginning on or after January 1, 1993.

56. **Rev. Proc. 92-41, 1992-21 IRB 23 (5-26-92).** This procedure provided a simplified method for certain master and prototype, regional prototype and volume submitters who obtained favorable opinions, notices or advisory letters after January 1, 1990, to amend their documents to take advantage of the liberalized §§ 401(k) and 401(m) rules and the new § 414(s) definition of compensation adopted by the final regulations.

57. **Announcement 92-81, 1992-22 IRB 56 (6-1-92).** This announcement released a proposed revenue procedure and
requested comments regarding: (i) allowing employers without precise data available at reasonable cost to substantiate compliance with the new nondiscrimination requirements using a "reliable substitute;" (ii) allowing substantiation by "using snapshot" testing on a single representative day; (iii) authorizing employers to use a simplified method for determining their highly compensated employees; and (iv) absent significant changes, allow employers to test once every three years.

58. Notice 92-31, 1992-29 IRB 6 (7-20-92). This notice describes and requests comments on certain proposed changes in the general requirements for safe harbors in the final (well almost) §§ 401(a)(4) and 414(s) regulations. The proposals include:

a. Eliminate the requirement that a safe harbor plan provide uniform vesting and service crediting rules for all employees.

b. Significantly reduce the restrictions on service credit with another employer or during a leave of absence.

c. Significantly reduce restrictions on permitted offsets.

d. Expand imputed compensation rules under § 414(s) for leaves of absence and transfers.

e. Allow compensation adjustments for transferred employees.

f. Relax fresh-start rules both with respect to frozen accruals (allow adjustments for future compensation increases) and affected employees in merger and acquisitions transactions.

59. Notice 92-32, 1992-29 IRB 9 (7-20-92). This notice proposes and requests comments on a "PIA Offset" safe harbor.

a. The offset would still have to comply with the new § 401(1) rules.

60. Rev. Proc. 92-60, 1992-30 IRB 15 (7-27-92). This procedure modifies Rev. Proc. 91-66 to allow plan sponsors to request (i) TRA '86 determination letters that do not cover nondiscrimination issues, (ii) ESOPs and KSOPs, and (iii) plans that do not benefit highly compensated employees.

61. Proposed Regulations Under §§ 401(a)(4) and 410(b). 57 FR 35536 (8-10-92). This document proposes to amend the final regulations under §§ 401(a)(4), 410(b) and certain related nondiscrimination requirements. The proposed amendments delay the effective dates of the final regulations.

62. Notice 92-36, 1992-35 IRB 12 (8-31-92). This notice extends the remedial amendment period until the last day of the 1994 plan year. For plans maintained by tax-exempt or
governmental organizations, the deferral is generally until the last day of the 1996 year.

a. The notice also modified and extended the transition relief, including the availability of Alternative II-D, through the remedial amendment period.

63. Notice 92-37, 1992-36 IRB 16 (9/8/92). This notice proposes and requests comments on several proposals to the general test for determining whether the amount of benefits under a defined benefit plan are discriminatory. The proposals include:

   a. Expand service and compensation used in determining accrual rates.
   b. Relax fresh start rules.
   c. Expand option to group most valuable accrual rates.
   d. Provide a facts and circumstances "safety valve."
   e. Eliminate objective testing for benefits provided to former employees.

64. Rev. Rul. 92-76, 1992-38 IRB 5 (9/21/92). This ruling addresses the implementation of new Treas. Reg. § 1.401(a)(4)-5(b), which replaces the old early termination rules under Treas. Reg. § 1.401-4(c). In general, the new rules are much more flexible. The ruling also confirms that certain distributions, although subject to the possibility of repayment, are lump sum distributions under § 402(e)(4)(A) and declares Rev. Rul. 81-135, 1981-1, C.B. 203, obsolete.

C. GOOD FAITH COMPLIANCE IN THE TRANSITION YEARS.

1. Background.

   a. A "reasonable, good faith" standard of compliance applies to certain Code sections during the "transition" years.

      (1) The purpose of the standard is to provide reliance in the period between the statutory effective date and the effective date of regulations.

      (2) The transition years are the 1989, 1990, 1991 and 1992 plan years.

      (3) Depending on the Code section, the good faith standard applies to one or more years.

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2The assistance of Catherine M. Marriott with this portion of the outline is acknowledged with appreciation.
See IRS Memos, 10-16-91 and 6-12-92, RIA Pension and Profit Sharing 2d ¶ 64,305 and ¶ 64,307.

b. The good faith standard applies to §§ 401(a)(4), 401(a)(17), 414(r) and to the average benefit percentage test under § 410(b).

c. Good faith reliance is not available for §§ 401(a)(26), 401(l) and 401(a)(5), 410(b), 411, 414(q), 414(s), and 415.

d. Standard of Review.

(1) Generally, reasonable good faith compliance means following policies established prior to TRA '86 except where modified by statute.

(2) A reasonable interpretation of relevant statutory provisions is deemed to be reasonable, good faith compliance.

2. Compliance.

a. § 401(a)(4)

(1) Revenue Ruling 81-202, 1982-2 C.B. 93, ("comparability") may be followed for the 1989, 1990 and 1991 plan years, with some modifications. Of course, the rules in the § 401(a)(4) regulations also can be followed.

(a) Testing may be done using projected benefits and reasonable groupings of compensation ranges.

(b) But, any comparability testing must take into account the § 401(a)(17) limits and use a § 414(s) definition of compensation.

(c) The rules on imputing permitted disparity in Revenue Ruling 81-202 also have been revised to reflect the § 401(l) changes.

(2) Nondiscriminatory availability of benefits, rights and features.

(a) The final regulations on optional forms of benefits (Treas. Reg. § 1.401(a)-4 and Treas. Reg. § 1.411(d)-4) must be followed for the 1989 through 1991 plan years. Optional forms of benefits must be currently and effectively available as described in Treas. Reg. § 1.401(a)-4, Q/A 1-6. Beginning with the 1992 plan year, the rules in the § 401(a)(4) regulations must be followed.

(b) Note that the average benefit percentage test does not apply to an optional form of benefit.
(c) The testing standard is stricter in 1992.

1) Each optional form of benefit subject to different terms affecting its value (such as actuarial assumptions on the method of benefit calculation) must separately satisfy § 401(a)(4).

2) Ancillary benefits are subject to the general nondiscrimination requirements for years before 1992.

(3) Past Service Credit

(a) Revenue Ruling 62-139, 1962-2 C.B. 123, and Revenue Ruling 81-248, 1981-2 C.B. 91, state the general rule that past service credit must not significantly discriminate in favor of the prohibited group.

(b) This is the relevant standard for the transition years. Also, any plan that has a final determination letter (FDL) that covers a grant of past service credit will be deemed to have provided nondiscriminatory grants of past service.

(4) Restrictions on Early Termination

(a) The § 401(a)(4) regulation is less restrictive.

(b) For distributions after May 14, 1990, the plan sponsor may apply either the prior rule (an escrow arrangement) or the new rule.

(c) For the 1989, 1990 and 1991 plan years, the plan sponsor may apply the prior rule.

(5) Employee Contributions

(a) Employee contributions do not need to separately satisfy § 401(a)(4) prior to 1992 if the total benefit provided by the plan is the same for all participants and if each participant contributes at the same level.

(b) Plans which have mandatory contributions may treat all benefits as being derived from employer contributions if mandatory contributions cease by the end of 1991.

b. Coverage (§ 410(b))

(1) Nondiscriminatory Classification. For 1989, a plan's classification will be treated as nondiscriminatory if the plan has an FDL and if there have been no significant changes in or omissions of material fact.
(2) Average Benefit Percentage Test

(a) A reasonable good faith interpretation of the statutory provision is sufficient.

(b) All plans maintained by the employer must be taken into account.

(c) Employees who receive no employer-derived contribution must be included as a zero.

(3) Benefitting. The 1989 transition rule applies to an employee who does not benefit due to a last day rule or failure to meet a service requirement.

(4) Separate Line of Business

(a) The proposed regulations are effective for 1992 plan years. Before 1992, an employer can satisfy the SLOB exception if it reasonably determines that it meets the requirements.

(b) The requirements:

1) a "bona fide" business reason for the SLOB;

2) the SLOB provides property or services to customers unrelated to the employer;

3) 50 non-excludable employees; and

4) the SLOB is not part of an affiliated service group.

c. Compensation Cap (§ 401(a)(17))

(1) Adjustment

(a) Generally, the increase in the compensation cap is taken into account for the plan year the increase is effective.

(b) For 1989, the 1990 limit may be used.

(2) Timing. For 1989 and 1990, the compensation cap effective on January 1 may be used with respect to a plan year that ends in that year.

d. Participation (§ 401(a)(26))

(1) Generally, a plan may be amended by the last day of the plan year to retroactively satisfy § 401(a)(26).

(2) Retroactive correction may also occur as late as the last day of the 1992 plan year.
3. Model Amendments.

   a. Retroactive correction may be accomplished by a retroactive allocation or by "wearing away" an excess allocation.

   b. Highly compensated employees may be removed from a plan if Model Amendment II or III was adopted.

II. SMOKE AND MIRRORS: THE NEW REQUIRED DIRECT ROLLOVER OPTION.

A. THE GOOD NEWS. Expanded rollover opportunities.

1. Existing Rules.

   a. Qualified Total Distributions
   b. Partial Distributions - The 50% Rule
   c. Plan terminations


   a. All taxable distributions from qualified plans and § 403(b) annuities are "eligible rollover distributions," except:

      (1) Annuities paid over life or life expectancy;

      (2) Installments for a period spanning ten years or more; and

      (3) Required minimum distributions under § 401(a)(9).

   b. The regulations provide that the rules employed under § 72(t)(2)(A)(iv) (pertaining to the additional 10% tax on pre-mature distributions) will be employed in determining whether a distribution is part of a series of substantially equal payments for a specified period. See Notice 89-25, 1989-1 C.B. 662.

      (1) Such determinations are made at the time distributions commence and without regard to any contingencies or modifications that haven't yet occurred (e.g., the employee's death).

      (2) After the occurrence of such a contingency, a new determination must be made regarding subsequent payments.

      (3) Social security supplements and other "leveling options" will not cause a distribution to fail to be substantially equal.
c. Corrective and deemed distributions are excepted from the definition of an eligible rollover distribution.  
E.g.,:

(1) returns of excess contributions or deferrals under $401(k) plans;
(2) deemed distributions of "P.S. 58" costs; and
(3) deemed distributions applicable to defaults on plan loans.

Although these exceptions are addressed in the regulations, the results are not clear from the statute.  They are, however, expected to be addressed as technical corrections.

d. Small distributions.  An employer may, but does not need to, provide the direct rollover option for distributions of less than $200.  Such distributions may, however, still be eligible to be rolled over under traditional rollover rules.

(1) As before, such distributions are not subject to withholding.

Again, this exception is not addressed in the statute.  A provision in H.R. 11, The Revenue Act of 1992, would have addressed this issue and increased the amount to $500.

e. IRAs.  The new rules do not apply to distributions from an IRA.

B. THE NOT SO GOOD NEWS.

1. All qualified plans and tax sheltered or § 403(b) annuities must now provide a direct rollover option. §§ 401(a)(31), 403(b)(10).

a. In the case of qualified plans, the requirement is a qualification issue.

b. The Service intends, in due course, to publish a model amendment that, if adopted, will not require a new opinion or determination letter, as to whether a plan, as amended, continues to satisfy § 401(a) qualification requirements.

2. Plan participants and annuity holders may elect to have the plan sponsor or insurer make a direct rollover to an individual retirement account (IRA), individual retirement annuity, or another qualified plan or § 403(b) annuity that accepts rollovers (an eligible retirement plan).  Such transfers may be affected by any reasonable means of delivery.

a. "Reasonable means of delivery" includes delivery of a check payable to the trustee of the recipient plan or
IRA sponsor to the distributee for delivery to the eligible retirement plan.

(1) The check must be made out in a manner to ensure that the check is negotiable solely by the trustee.

b. An employee may elect to make a direct rollover of a portion of an eligible distribution and receive a portion directly.

(1) An employer may limit such direct rollovers to a minimum of $500.

c. An employer does not have to provide direct rollovers to more than one eligible retirement plan.

d. An employer is not required to permit direct rollovers to its qualified plans.

3. The direct rollover option is in addition to the existing regular rollover options available under § 402.

C. THE BAD NEWS.

1. Mandatory 20-percent income tax withholding is imposed on eligible rollover distributions that are not directly rolled over. § 3405.

a. The mandatory withholding applies even where a distribution is rolled over within 60 days under the current rules.

b. Generally, the applicable voluntary withholding rules pertaining to distributions of property under § 3405 also apply. Thus, if property (other than "employer securities") is distributed, and the cash in the distribution will not satisfy the withholding obligation, the entity making the distribution must either sell the property or be provided cash by the employee to cover the withholding.

(1) As under the current rules, employer securities need not be sold to satisfy the withholding requirements.

c. The current elective withholding rules continue to apply with respect to distributions that are not eligible rollover distributions.

2. A plan administrator will not be liable for failing to withhold on an eligible rollover distribution that is not in fact paid to an eligible retirement plan if it reasonably relied on adequate information provided by the distributee.

a. Adequate information includes:

(1) The name of the recipient plan;
(2) A representation that the recipient plan is an eligible retirement plan;

(3) Any other information necessary to accomplish the direct rollover by the means selected for delivery.

3. Direct rollovers will be reported by the payer on Form 1099-R. IRA trustees but not qualified plans will be required to report receipt of transfers on Form 5498.

D. THE NOTICE REQUIREMENTS.

1. Within a reasonable time before making an eligible rollover distribution, the administrator of a qualified plan must give the potential distributee a written explanation of:

   a. the availability of the direct rollover option;

   b. the applicable withholding requirements;

   c. the rules pertaining to traditional rollover rights; and

   d. where applicable, the other special tax rules (e.g., five-year averaging, unrealized appreciation on employer securities) that may apply to the distribution. § 402(f).

2. The Internal Revenue Service has published a model § 402(f) notice that employers may use as a safe harbor. Notice 92-48, IRB 1992-45 (Nov. 9, 1992). See Exhibit I.

   a. The model notice may be "customized" by omitting any portion that could not apply to the plan in question.

   (1) For example, the portions of the model notice dealing with after tax contributions and employer securities may be deleted if inapplicable to a plan.

3. The § 401(a)(11) rules applicable to the notice requirements relating to QPSAs and QJSAs have been adopted for purposes of the new § 402(f) rules. Generally, this means that a "reasonable time period" means no less than 30 days and no more than 90 days before the applicable "annuity starting date."

   a. Where § 401(a)(11) doesn't apply, e.g., where a participant has reached his normal retirement age or a cashout benefit doesn't exceed $3,500, the rules provide that a qualified plan participant may waive the application of the 30 day rule by affirmatively electing to make or not make a direct rollover.

4. Transition Relief. In the case of § 402(f) notices that would be required to be given in 1992, for distributions to be made in 1993, employers may rely on a reasonable good faith interpretation of § 402(f).
a. Special "make up" rules allow an employer to defer withholding on otherwise applicable distributions made during the first three months of 1993, if compliance would result in undue hardship, and if there will be further distributions prior to the end of 1993, from which the amounts otherwise required to be withheld can be withheld.

b. Otherwise applicable failure to withhold penalties will be automatically abated with respect to distributions made from January 1 - June 30, 1993, if the payor has acted diligently and in good faith in attempting to comply with the new rules.

5. Tax Deposits. The requirements for depositing withheld taxes have not changed. See Announcement 84-40, 1984-17 IRB 31, regarding the alternative compliance options available to payors.

E. STATUTE AND REGULATIONS.


2. The UCA amended or enacted §§ 401(a)(31), 402(c), 402(f), 403(h) and 3405(c).

F. EFFECTIVE DATES.


   a. For example, in the case of a series of payments that began before December 31, 1992, the new rules would apply to post 1992 distributions.

   b. The application of the new rules are deferred with respect to certain § 403(b) arrangements sponsored by state and local governments.

   c. Temporary Regulations were issued in TD 8443 on October 20, 1992.

      (1) The regulations are in question and answer format.

   d. The Temporary Regulations estimated the approximate average time expected to be necessary for data collection to comply with the regulations at 2,116,300 hours per year.

G. EXAMPLE.

Your eligible rollover distribution is $10,000, and you choose to have it paid to you. You will receive $8,000 and $2,000 will be sent to the Service as income tax withholding. Within 60 days after receiving the $8,000, you may roll over $10,000 to an IRA or employer plan. To do this, you roll over the $8,000 you
received from the Plan, and you will also have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the $10,000 is not taxed until you take it out of the IRA or employer plan. If you roll over $10,000, when you file your income tax return you may get a refund of the $2,000 withheld.

If, on the other hand, you roll over only $8,000, the $2,000 you did not roll over is taxed in the year it was withheld. When you file your income tax return you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you roll over $10,000).

1. Obviously, the new rules provide a significant tax trap for plan participants.

2. Note, however, that nothing would prevent a plan participant from effecting a direct rollover to an IRA and then electing a distribution. Although this would avoid the mandatory withholding requirement, it would seem to make little sense, except in situations where the 20% withholding exceeds the likely tax on the distribution.

H. POSSIBLE ADDITIONAL LEGISLATIVE CORRECTIONS.

1. A clarification that hardship distributions under § 401(k) plans or attributable to earnings reduction contributions under § 403(b) are not eligible for rollover, and, thus, not subject to the 20% withholding requirement.

2. ESOP dividends passed through to participants in accordance with § 404(k) would be excluded.

3. It has been proposed that distributions to an "alternate payee" under a qualified domestic relations order should be excluded. The Temporary Regulations specifically included such distributions.

4. Certain continuing payments of distributions that commenced before 1993 would be excluded.

5. Certain pre-July 1, 1993 distributions attributable to 1992 events would be excluded, e.g., payments attributable to death, disability or separation from service.

6. Clarify that direct payments to an eligible retirement plan will be considered a plan distribution.

7. Authorize proportional direct rollovers subject to certain limitations.

III. THE DEPARTMENT OF LABOR ("DOL") AMNESTY PROGRAM: ARE THEY REALLY GOOD GUYS?


On March 23, 1992, the DOL’s Pension and Welfare Benefits Administration announced a program for assessing civil penalties

1. The program is effective for plan years beginning in 1988 and subsequent plan years.

2. Under ERISA § 502(c)(2), enacted as part of the Omnibus Budget Reconciliation Act of 1987 (OBRA '87), Pub. L. No. 100-203 (December 22, 1987), the DOL may assess civil penalties of up to $1,000 per day from the date of a plan administrator's failure or refusal to file an annual report pertaining to an employee benefit plan.

   a. Under the Amnesty Program, the DOL provided that a reduced penalty would apply to first time, late or corrective filers who file no later than September 30, 1992.

      (1) The penalty was reduced to $50 per day up to a maximum of $1,000. The penalties apply separately to each plan for each plan year.

      (2) Under the Program, plan administrators who voluntarily file annual reports for 1988 and subsequent years after their due dates are considered "late filers" and subject to a penalty of $50 a day per plan. Plan administrators who fail to file are considered "non-filers" and subject to a penalty of $300 a day per plan up to a maximum of $30,000 a year per plan.

      (a) The DOL announcement does not say when a "late filer" becomes a "non-filer."

3. The DOL News Release made it clear that it only related to ERISA Title I penalties. Since the Internal Revenue Service shares jurisdictional authority with respect to certain employee benefit plans, the DOL noted that an amnesty filing would not necessarily prevent the IRS from imposing additional sanctions. The Release noted, however, that "the IRS ... has indicated it will consider the good faith efforts of ... filers who take advantage of the ... grace period in determining what, if any, penalties the IRS may impose."

4. Filers taking advantage of the program also had to waive their rights both to contest the assessment and to receive written notice of it.


7. The DOL views the Amnesty Program as an answer to the Service's Closing Agreement Program (CAP).

B. TOP HAT PLANS.

DOL Reg. § 2520.104-23, exempts so-called top hat plans from most of ERISA reporting and disclosure requirements. Such plans must, however, file a one-page registration statement to comply with these rules within 120 days of the date a plan is adopted. It was initially unclear how such plans were impacted by the Amnesty Program.

1. A top hat plan is an unfunded plan maintained by an employer primarily for the purpose of providing deferred compensation for a select group of management or highly compensated employees.

2. On July 30, 1992, the DOL issued a notice clarifying that a top hat plan may file the certification required by DOL Reg. 2520.104-23(b), rather than annual returns for 1988 and subsequent plan years and pay one $1,000 penalty for all such years.

3. Multiple plans may be covered by a single filing with respect to such plans.


C. WHAT IS A PLAN FOR ERISA PURPOSES?

1. The terms "employee welfare benefit plan" and "welfare plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an employer or by an employee organization, or by both, to the extent that such plan, fund, or program was established or is maintained for the purpose of providing for its participants or their beneficiaries, through the purchase of insurance or otherwise, (A) medical, surgical, or hospital care or benefits, or benefits in the event of sickness, accident, disability, death or unemployment, or vacation benefits, apprenticeship or other training programs, or day care centers, scholarship funds, or prepaid legal services, or (B) any benefit described in section 302(c) of the Labor Management Relations Act, 1947 [29 USCS § 186(c)] (other than pensions on retirement or death, and insurance to provide such pensions).

2. Generally, the terms "employee pension benefit plan" and "pension plan" mean any plan, fund, or program which was heretofore or is hereafter established or maintained by an
employer or by an employee organization, or by both, to the extent that by its express terms or as a result of surrounding circumstances such plan, fund, or program—

a. provides retirement income to employees, or

b. results in a deferral of income by employees for periods extending to the termination of covered employment or beyond,

regardless of the method of calculating the contributions made to the plan, the method of calculating the benefits under the plan or the method of distributing benefits from the plan.

The Secretary may by regulation prescribe rules consistent with the standards and purposes of this Act providing one or more exempt categories under which—

a. severance pay arrangements, and

b. supplemental retirement income payments, under which the pension benefits of retirees or their beneficiaries are supplemented to take into account some portion or all of the increases in the cost of living (as determined by the Secretary of Labor) since retirement,

shall, for purposes of this title, be treated as welfare plans rather than pension plans. In the case of any arrangement or payment a principal effect of which is the evasion of the standards or purposes of this Act applicable to pension plans, such arrangement or payment shall be treated as a pension plan.

3. The regulations exempt various arrangements and practices from these definitions including, under certain circumstances: various payroll practices; certain on-premises recreation and dining facilities; holiday gifts; dining hall facilities; remembrance funds; strike funds; industry advancement programs; certain group insurance arrangements; unfunded scholarship funds; severance pay plans; bonus programs; individual retirement accounts; pre-ERISA gratuitous payment arrangements; tax sheltered annuities; supplemental pay plans and certain payments to pre-1977 retirees.

4. In addition to the general exemptions mentioned in 3 above, the regulations also provide various specific exemptions that may modify or eliminate the need to file an annual report. Examples of such regulations include:

a. Welfare plans covering fewer than 100 participants at the beginning of a plan year which pay benefits from the employer’s general assets, provide benefits through insurance with premiums paid from its general assets or partly from its general assets and by employee contributions, or both. Certain restrictions also apply with respect to paying over employee premium payments to an insurer and premium refunds. DOL Reg. § 2520.104-20.
b. Apprenticeship and training plans that comply with certain minimal requirements. DOL Reg. § 2520.104-22.

c. Unfunded or insured welfare benefit plans providing such benefits for a select group of management or highly compensated employees which are paid for from the employer's general assets, from insurance contracts paid for by the employer from its general assets, or both. DOL Reg. § 2520.104-24. A similar rule applicable to employee pension benefit plans maintained for such persons that reduces but doesn't eliminate the reporting obligations for such plans is discussed at B above.

d. Day Care Centers. DOL § 2520.104-25.

e. Certain dues financed pension plans maintained by employee organizations are provided an alternative means of compliance. DOL Reg. § 2520.104-27.

f. Certain group insurance arrangements covering more than 100 participants that otherwise satisfy the requirements of DOL § 2520.104-21 and as to which an annual report has been filed with DOL by the trust or other entity which holds the group contracts in question. DOL § 2520.104-43.


5. Other Issues. The more difficult interpretative and compliance issues associated with the program have involved issues such as how to deal with employee assistance programs (EAPs), supplemental gratuitous or contractual payments made to retirees, or scholarship programs, cafeteria plans and filings with the IRS required under § 6039(d) but not with DOL.

a. Note that filings need to be made with IRS with a request for the abatement of penalties in certain cases even where a DOL filing is not required.

IV. A KINDER, GENTLER INTERNAL REVENUE SERVICE?


Although any operational violation technically disqualifies a plan, the Service acknowledged that certain operational violations may be so minor that it is not productive for the Service to pursue disqualification. To treat such a violation as nondisqualifying, six criteria must be satisfied.

1. The operational violation must be an isolated, insignificant instance.
2. The plan in question must have a history of compliance or the violation must have been corrected before examination, and there is no evidence of noncompliance in other areas.

3. The plan sponsor or plan administrator must have established practices and procedures (formal or informal) to ensure compliance with § 401(a), and to assure the violation will not recur.

4. The violation must have occurred through an oversight or mistake in applying the procedures not as a result of failing to follow them.

5. If dollar amounts are involved, they must be insubstantial in view of the total factor of the case.

6. The plan sponsor must have made an immediate and complete correction to cure the violation once it was discovered. I.R.S. Memo, 3-26-91. See RIA Pension and Profit Sharing 2d ¶ 64,303.

B. CLOSING AGREEMENT PROGRAM (CAP).

1. In December 1990, the Service announced the development of a pilot closing agreement program for employee plans cases. I.R.S. Memo, 12-21-90. See RIA Pension and Profit Sharing 2d ¶ 64,301.

2. The program was developed under § 7121 as a mechanism to resolve disputes between the Service and plan sponsors that normally result in plan disqualification.

3. The program is not available to resolve issues involving:
   a. significant discrimination in favor of highly compensated employees;
   b. exclusive benefits violations resulting from diversions of plan assets; or
   c. repeated, deliberate, or flagrant violations.

4. Corrections had to be made for all plan years whether or not the statute of limitations remained open.

5. Retroactive contributions were subject to the normal deduction rules. § 404.

6. The plan sponsor had to agree to pay a non-deductible penalty to the U.S. Treasury.
   a. The maximum penalty was equivalent to the total tax resulting from the disallowance of the plan sponsor's tax deduction for contributions to the plan, the treatment of trust income as taxable, and the inclusion in plan participants' incomes of their appropriate shares of plan contributions.
b. The objective was a penalty equal to 100% of this amount. The penalty was, however, negotiable.

7. The procedures called for "plan perfection".

8. Sample agreements are set forth in the memorandum.

9. The CAP program was made permanent on October 9, 1991.

I.R.S. Memo, 10-9-91. See RIA Pension and Profit Sharing 2d ¶ 64,304.

C. VOLUNTARY COMPLIANCE RESOLUTION PROGRAM ("VCR PROGRAM").


2. The VCR Program is a voluntary program to encourage plan sponsors to identify and correct operational plan defects.

   a. Unlike the Closing Agreement Program (CAP), the VCR Program does not involve monetary sanctions. There will, however, be a fixed voluntary compliance fee. This fee is administered under the user fee program. See Rev. Proc. 90-17, 1990-1 C.B. 479.

   b. The VCR Program is effective immediately (presumably, November 16, 1992, and not October 28, 1992 the date of the procedure's advanced release) and will be available until December 31, 1993.

      (1) The program is experimental, it is unclear whether it will be extended or expanded.

      (2) A plan sponsor who has contacted the Service by December 31, 1993, will be eligible for the program.

   c. A plan that is under examination (i.e., its Form 5500) is not eligible for the VCR Program.

      (1) Written or verbal notice from the EP/EO Division to a plan sponsor, or its representative, is sufficient.

      (2) For this purpose, "examination" includes an examination that is in Appeals or litigation on issues raised in an examination.

      (3) An examination of one of a plan sponsor's plans does not exclude its other plans from access to
the VCR Program unless they are aggregated with the plan under examination for purposes of complying with § 401(a).

d. The Service will not make any findings of violations under the VCR program. Plan sponsors must identify each item to be considered under the program as an operational violation. Such statements are not to be used by the Service for any other purpose.

e. The corrections deemed necessary by the Service will be set forth in a "compliance statement" issued by the Service. Corrections must be made for all years for which the defects exist, whether or not closed by the statute of limitations. The corrections must be made within the time period set forth in the compliance statement.

(1) Within 21 days of issuance (not receipt), the plan sponsor is required to send a signed acknowledgment letter to the Service, agreeing to the terms of the compliance statement.

f. The Service must also be satisfied that the plan sponsor has initiated or will initiate administrative procedures to assure that operational defects will not recur and that the plan will be properly administered. The Service reserves the right to prescribe appropriate administrative procedures in the "compliance statement."

(1) The Service also reserves the right to verify that the defects have been corrected and that any changes in administrative procedures have been made.

g. If resolution cannot be reached, or if on follow-up it is determined that the required changes have not been made, the case may be referred to the appropriate EP/EO Key District Office for consideration for examination.

h. All information submitted or generated under the program with respect to a case is subject to applicable confidentiality requirements. See § 6103.

i. The resolution of a defect under the VCR Program has no effect on any party’s rights under TITLE I OF ERISA.

j. SCOPE.

(1) The VCR Program is only available for plans that received favorable determination letters with respect to changes mandated by TEFRA, DEFRA and REA.

(2) Exclusive benefit violations relating to the misuse or diversion of plan assets may not be corrected under the VCR Program.
(3) Repeated, deliberate or flagrant violations may not be corrected under the VCR Program.

(4) Generally, operational defects which give rise to income tax issues rather than disqualification issues are not eligible for the VCR Program because the statute already provides specific tailored sanctions, e.g., funding deficiencies and prohibited transactions.

(a) The VCR Program will, however, be available to correct defects arising under §401(a)(9) or 401(k). A closing agreement will be used to resolve the tax related issues.

k. While the VCR Program is in effect, the CAP program is not available for corrections that may be made under it. However, during an undefined transition period, plan sponsors who are currently negotiating a closing agreement on a "walk-in" basis, will be contacted and given an opportunity to switch to the VCR Program if the defects in question could be corrected under the VCR Program.

1. FEES

(1) $500 - plans with less than $500,000 in assets and no more than 1,000 participants.

(2) $1,250 - plan assets of at least $500,000 and no more than 1,000 participants.

(3) $5,000 - plans with more than 1,000 but less than 10,000 participants.

(4) $10,000 - plans with 10,000 or more participants.

m. In general, a request for a "compliance statement" is made by writing the National Office, outlining the defects and describing the proposed method of correction. The specific information to be included is outlined at Section 6.02 of Rev. Proc. 92-89. The information must be submitted under penalties of perjury. The submission or an appearance in regard thereto may be made by any person complying with Section 9.01(9) of Rev. Proc. 92-4, 1992-1 - I.R.B. 65, e.g., attorney, certified public accountant, and enrolled agents.

(1) If the Service requests additional information, it must be submitted within 21 days of the date of the request. Extensions must be requested in writing.
V. PARTICIPANT DIRECTED INDIVIDUAL ACCOUNT PLANS.

A. INTRODUCTION.

ERISA § 404(c) relieves fiduciaries of exposure for any loss or by reason of any breach which results from the exercise of control by a participant or beneficiary under certain individual account plans. Participants or beneficiaries are not considered fiduciaries as a result of exercising such control.

1. Regulations were proposed under ERISA § 404(c) in both 1987 and 1991. They were finalized and sent to the Federal Register for publication on October 9, 1992. F.R. Doc. 92-24357, 57 Fed. Reg. 46906.

   a. Note that it took 13 years for the Department of Labor to propose these regulations and 18 years to finalize them.

2. The regulations state specifically that they are to be applied solely for purposes of determining whether a plan is an ERISA § 404(c) plan and whether a particular transaction engaged in by a participant or beneficiary is afforded relief by ERISA § 404(c). They specifically state that the standards are not intended to be applied in determining whether, or to what extent, a plan which does not meet the requirements for an ERISA section 404(c) plan or a fiduciary with respect to such a plan satisfies the fiduciary responsibility or other provisions of Title I of ERISA.

B. ERISA § 404(c) PLANS.

1. An individual account plan, described in ERISA § 3(34), that (i) provides an opportunity for a participant or beneficiary to exercise control over assets in his individual account, and (ii) provides a participant or beneficiary an opportunity to choose from a broad range of investment alternatives the manner in which some or all of the assets in his account are invested.

   a. A plan provides an "opportunity to exercise control over assets in his account" only if:

   (1) A participant or beneficiary has a reasonable opportunity to give investment instructions (in writing or otherwise, with an opportunity to obtain written confirmation of such instructions) to an identified plan fiduciary who is obligated to comply with such instructions; and

   (2) The participant or beneficiary is provided or has the opportunity to obtain sufficient information to make informed decisions with regard to investment alternatives available under the plan. A participant or beneficiary will be considered to have sufficient investment information if:
(a) An identified plan fiduciary (or his designate) provides plan participants and beneficiaries:

1) An explanation stating that the plan is intended to be an ERISA § 404(c) plan and that plan fiduciaries may be relieved of liability for losses resulting from a participant's or beneficiary's investment instructions;

2) A description of the plan's investment alternatives and a general description of the investment objectives and risk/return characteristics of each, including information relating to the type and diversification of its assets;

3) The identification of designated investment managers;

4) An explanation of the circumstances under which participants or beneficiaries may give investment instructions and any limitations, including any transfer restrictions on such instructions and any restrictions on the exercise of voting, tender and similar rights applicable to investments generally or a specific investment;

5) A description of any transaction fees and expenses applicable to an investment alternative (e.g., commissions, sales load, defined sales charges, redemption or exchange fees);

6) The name, address and phone numbers of the plan fiduciary (or its designate) responsible for providing certain required information to the participant or beneficiary upon request and a description of the information that may be obtained upon request;

7) If investments may be made in employer securities, a description of the procedures established to provide for the confidentiality of information relating to the purchase, holding and sale thereof and the exercise of voting, tender and similar rights, and the name, address, and phone number of the fiduciary responsible for monitoring compliance with the procedures;

8) A copy of the prospectus pertaining to any investment alternative subject to registration under the Securities Act of 1933 immediately before or immediately following the
participant's or beneficiary's initial investment; and

9) Information provided to the plan by an investment alternative regarding voting, tender and similar rights if such rights are passed through as well as references to applicable plan sections.

(b) The identified plan fiduciary (or its designate) must provide directly or on request, various information, based on the latest information available to the plan, including:

1) a description of each designated investment's fees (e.g., investment, management, administrative and transaction costs) and the aggregate of such expenses as a percentage of average net assets of the designated investment alternative;

2) copies of prospectuses, financial statements, reports and other materials provided to the plan by an investment alternative;

3) a list of the assets of each designated investment alternative and each such asset's value, and, with respect to each fixed rate investment contract issued by a bank, savings and loan or insurance company, the name of the issuer, the terms of the contract and the rate of return; and

4) information regarding the value of units or shares of any investment alternative available under the plan and current and historical performance information, determined, net of expenses, on a reasonable and consistent basis.

(c) A plan does not fail to provide an opportunity for a participant or beneficiary to exercise control over his account merely because:

1) it imposes charges for reasonable expenses and periodically informs participants and beneficiaries of actual expenses incurred with respect to their accounts;

2) it permits a fiduciary to decline to implement investment instructions that would:

   a) result in a prohibited transaction under § 4975 or ERISA § 406; or

   b) which would generate taxable income to the plan;

-31-
3) it imposes reasonable restrictions on the frequency of investment instructions which are appropriate based on the volatility of the applicable investment alternative, provided that,

a) at least three of the investment alternatives constituting a broad range of investment alternatives (the "core investments") must permit investment instructions no less frequently than once within any three month period, and

b) where applicable, one of such investment alternatives allows participants to transfer into such alternative as often as any other investment option which allows instructions more frequent than once every three months, or

c) with respect to each such investment alternative, it may be transferred into an income producing low risk, liquid fund, subfund, or account ("safe fund") as frequently as instructions are permitted with respect to such fund and may be transferred out of such fund at least as regularly as transfers may be made from the three investment alternatives constituting a broad range of investment alternatives, and

d) generally, participants or beneficiaries have to have the same rights to transfer into the "core investments" or "safe fund" as frequently as they have the right to direct investments with respect to any employer security alternative.

(d) Independent control.

1) Broad range of investments.

a) Participants and beneficiaries must have the opportunity to materially affect the potential return on their individual accounts and the degree of risk to which they are subjected;

b) They must be able to choose from at least three investment alternatives, each of which: (i) is diversified; (ii) has materially different risk and return characteristics; (iii) enables a participant or beneficiary to select a portfolio with aggregate risk and return characteristics appropriate for him; and (iv)
provides the opportunity through combination and diversification to reduce overall risk;

c) They must be able to diversify the investment of the portion of their accounts they are permitted to invest so as to minimize large losses; and

d) Look-through investments must be made available where they are the only prudent means to assure an opportunity to achieve appropriate diversification. The underlying investments of a look-through investment are considered in determining whether the requirements of b) and c) above are satisfied. Such investments include mutual funds, bank common trust funds, pooled separate accounts or fixed rate contracts of an insurance company and certain other pooled investments constituting plan assets.

C. EXERCISE OF CONTROL.

1. ERISA § 404(c) only applies to transactions in which a participant or beneficiary has in fact exercised independent control.

   a. A participant or beneficiary will be deemed to have exercised control with respect to the exercise of voting, tender and similar rights where such control was exercised with respect to the investment alternative itself and he was provided a reasonable opportunity to give instructions with respect to such incidents of ownership.

2. A participant's or beneficiary's control is not independent if:

   a. The plan sponsor subjects the participant or beneficiary to improper influence;

   b. A plan fiduciary has concealed material non-public facts regarding the investment alternative from participants or beneficiaries, unless disclosure would violate federal law or state law not preempted by ERISA.

   c. The plan fiduciary accepts instructions from a participant or beneficiary he believes is legally incompetent.

3. Transactions involving a fiduciary.

   a. A participant or beneficiary will not be deemed to have exercised independent control with respect to a transaction (excluding any transaction that would be a
prohibited transaction) with a plan fiduciary. Transactions in which the participant or beneficiary pays no more, or receives no less than adequate consideration will be deemed to be fair and reasonable.

4. A plan fiduciary has no obligation under part 4 of Title I of ERISA to provide investment advice to a participant or beneficiary.

D. LIMITATION ON LIABILITY.

1. The limitation on fiduciary liability otherwise available under ERISA § 404(c) does not apply to any instruction which:

a. is not in accordance with a plan’s governing documents insofar as they are consistent with Title I of ERISA;

b. would cause a fiduciary to maintain indicia of ownership outside the jurisdiction of U.S. district courts;

c. could jeopardize a plan’s tax qualification;

d. could result in a loss in excess of a participant’s or beneficiary’s account balance; or

e. would constitute a prohibited transaction.

(1) ERISA § 404(c) provides no relief from the excise taxes imposed on prohibited transactions under §§ 4975(a) and (b).

2. A plan fiduciary (other than the investment manager) shall not be liable for investments made by an investment manager selected by a participant or beneficiary.

E. EMPLOYER SECURITIES.

1. Special rules also apply with respect to investments in employer securities.

a. They must be "qualifying employer securities" under ERISA § 407(d)(5).

b. Such securities are stock or an equity interest in certain existing publicly traded partnerships.

c. Such securities are publicly traded on a national exchange or other generally recognized market.

d. Such securities are traded with sufficient frequency and in sufficient volume to assure that participant and beneficiary directions to buy or sell the security may be acted upon promptly and efficiently.
Participants and beneficiaries with accounts holding such securities receive information provided to shareholders thereof.

Voting, tender and similar rights are passed through.

Information relating to the purchase, holding and sale of securities, and the exercise of voting, tender and similar rights with respect to such securities by participants and beneficiaries is maintained in accordance with procedures which are designed to safeguard the confidentiality thereof, except to the extent necessary to comply with federal law or state law not preempted by ERISA.

The plan must designate a fiduciary who is responsible for ensuring that (i) the procedures outlined in f above are sufficient to safeguard the confidentiality of such information, (ii) such procedures are being followed and (iii) for appointing an independent fiduciary where required.

An independent fiduciary must be appointed to carry out activities relating to any situation which the designated plan fiduciary determines involves a potential for undue employer influence upon participants and beneficiaries with regard to the direct or indirect exercise of shareholder rights.

(1) An affiliate of the sponsor cannot be an independent fiduciary.

VI. EXECUTIVE COMPENSATION UPDATE.

A. INTRODUCTION.

In recent years, various limits on benefits that can be paid or accrued under qualified plans, e.g., the compensation cap (§ 401(a)(17)), maximum accruals or annual additions (§ 415), and earnings deferrals and employee contribution limitations (§ 402(g), 401(k)(3), and 401(m)) have heightened the interest of plan sponsors in such arrangements. In many cases, such arrangements may be less expensive to maintain than a qualified plan subject to a multiplicity of nondiscrimination and compliance problems. Although elective deferrals make questionable sense given current tax rates, this may change if tax rates on high wage earners were to increase.

Employers are continuously seeking ways to secure the promises made under nonqualified deferred compensation arrangements to relieve the "executive paranoia" that exists with respect to them. Several important recent developments are worth noting.

1. Note that several bills in Congress would set limits on the deductibility of executive compensation. Such provisions are supported by President-Elect Clinton and would have
a significant impact on nonqualified deferred compensation arrangements.

B. CONSTRUCTIVE RECEIPT.

One of the most difficult tax issues to engage in the context of such arrangements is the concept of constructive receipt. The Service's long standing ruling posture is set forth in Rev. Proc. 71-19, 1971-1 C.B. 698. The courts have generally upheld arrangements much more favorable to taxpayers.

1. **Martin v. Commissioner**, 96 T.C. No. 39 (1991). **Martin** involved a fact situation in which an employer was substituting a nonqualified plan which provided the option of a lump sum distribution or a 10 year installment payout for one which contained only a 10 year installment payout. The taxpayers elected a 10 year payout under the new plan and were held in constructive receipt. The court held that there was no constructive receipt.

   a. Although **Martin** is important and widely cited as a breakthrough on the constructive receipt issue because of Judge Gerber's correct and helpful language regarding elections made before the benefits in question become due and payable, the "novation theory" (see **Veit v. Comm.**, 8 T.C. 809, 818 (1947); **Kimbell v. Comm.**, 41 B.T.A. 940 (1940)) and the forfeitures encountered by the taxpayers in this instance were significant factors in the result not present in all cases.

2. **Rev. Proc. 92-65, 1992-33 IRB 11 8-17-92.** In this Revenue Procedure, the Service amplified Rev. Proc. 71-19, and formalized two exceptions to the general rule that "elections" to defer compensation must be made before the beginning of the period of service for which the compensation in question is payable (regardless of the existence of forfeiture provisions). Usually, the period in question is the individual's taxable year. The two exceptions that have appeared over the last several years in numerous letter rulings include:

   a. For new plans, an election can be made by eligible employees "within 30 days after the date the plan is effective" with respect to compensation for services performed thereafter; and

   b. In the year a participant first becomes eligible for a plan, he may make an election within 30 days of the date he becomes an eligible employee with respect to compensation for services performed thereafter.

   c. Nonqualified plans must define the time and method of payment of deferred compensation for each event.

      (1) A plan may, however, provide for the payment of benefits in the case of an "unforeseeable emergency."

-36-
An "unforeseen emergency" must be defined as an emergency that is caused by an event beyond the control of the participant or beneficiary and that would result in severe financial hardship to the individual if early withdrawal were not permitted. Such withdrawals must be limited to the amount necessary to meet the emergency.

d. Plan participants must have the status of general unsecured creditors and if a trust is used in conjunction with the arrangement, it must comply with Rev. Proc. 92-64, 1992-33 IRB 11 (8-17-92).

C. RABBI TRUSTS.

So-called "rabbi trusts" are widely used in conjunction with nonqualified deferred compensation arrangements. Except with respect to mergers and acquisitions and as a means to address executive paranoia, such vehicles have little legal significance. The Service has, however, provided a model grantor trust that may be used for this purpose and must, except in rare and unusual circumstances, be used if a plan sponsor wishes to obtain a ruling on it. See Rev. Proc. 92-64.

1. Rev. Proc. 92-64 was effective July 28, 1992.

2. PLR 9235006 (11-4-91). The Service has approved the "funding" of a grantor trust with employer securities.

D. SECULAR TRUSTS.

To eliminate the uncertainty that existed with respect to rabbi trusts, so-called secular trusts have been used to take advantage of individual and corporate rate differentials and to vest benefits and put reserves securing an employer's promises beyond the reach of its creditors. Because benefits are vested, such vehicles result in immediate taxation of contributions or benefits as the trusts are funded. Employers had hoped, however, that the earnings on such reserves would be taxed to them under the grantor trust rules and be deductible by them as such amounts were allocated to participant accounts. The idea was to avoid tax at the trust level and effect an income and deduction wash at the employer level.

1. In four recent private letter rulings, the Service has made it clear that such trusts are taxable on their earnings and that such amounts will also be taxable to the executives, "... either under IRC §§ 402(b)(1) and 72 when distributed to them (in the case of non-highly compensated employees) or under IRC § 402(b)(2) when allocated to participants' trust accounts (in the case of highly compensated employees). See PLRs 9206009 (November 11, 1991), 9207010 (November 12, 1991), 9212019 (December 20, 1991 and 9212024 (December 20, 1991). Yale D. Tauber, Funding Alternatives for Non-Qualified Deferred Compensation Plans, Vol. 1 No. 32, RIA Pension and Profit Sharing 2nd, p. 17 (June 26, 1992).
2. Some practitioners have attempted to deal with this problem by giving trust beneficiaries the right to elect to receive all of the trust's earnings each year. In most situations, actual distributions are contemplated only of amounts necessary to pay the participant's current tax bill with respect to such earnings or additional contributions. Future Contributions are the stick to assure that the carrot is not eaten! See 9243034 (________, 1992).

E. SECURITIES LAWS DEVELOPMENTS.

1. Rule 16b-3 deferral. During 1991 the Securities and Exchange Commission promulgated new rules relating to "insider trading" in employer securities. The new rules were generally effective May 1, 1991. The rules extend to so-called "derivative securities" and require employee benefit plans to adopt administrative procedures complying with the new rules. Employee benefit plans were originally given until September 1, 1992, to comply with the new rules. Although employers may elect to comply early, the mandatory compliance date has been deferred until September 1, 1993. The sanctions for failure to comply with the new rules impose various disclosure and financial penalties (including paying any profit made on prohibited trading over to the issuer of the securities.)


a. The proposals are intended to insure that "all material facts regarding executive compensation are clearly and fairly disclosed."

b. The current more general disclosure would be replaced by a series of disclosure tables covering all aspects of executive compensation, including salaries and bonuses, option and stock appreciation right (SAR) grants and exercises, restricted stock grants, pension plan contributions and other long-term and deferred compensation.

(1) Most of this information would have to be provided for the last three fiscal years.

c. Proxy statements would also have to include a statement of the compensation committee of the issuer's board of directors describing the basis for the Committee's decisions regarding the compensation of the Chief Executive Officer during the last fiscal year and the relationship of such compensation to the issuer's performance.
VII. RECENT RULINGS OF INTEREST.

A. Rev. Rul. 92-66, 1992-36 IRB 11 (9-8-92). Guidance is provided as to when §§ 411(d)(6) and 401(a)(25) require that an early retirement window benefit be provided permanently. Ruling approved plan amendments making such benefits available for substantially consecutive, limited periods of time.

B. Rev. Rul. 92-69, 1992-36 IRB 5 (9-8-92). This ruling addresses several fact patterns in which employer-provided outplacement services may be totally or partially excluded from an employee's gross income and from FICA and FUTA taxes as a working condition fringe under § 132.

C. Rev. Proc. 92-10, 1992-2 IRB 20 (1-13-92). This procedure provided guidance regarding qualification issues and the imposition of the 50-percent excise tax under § 4974 where an individual's distribution could not be made because plan assets were invested in a state insurer involved in state delinquency proceedings.


E. PLR 9233054 (5-22-92). The Service ruled that an exchange of a nontransferable annuity contract distributed on the termination of a qualified plan for a substantially similar annuity contract issued by another insurer did not violate §401(g)'s nontransferability restrictions.

F. PLR 9242039 (______). Inclusion of employees of taxable subsidiaries in parent's self-insured medical/dental plan does not jeopardize parents § 501(c)(3) status, so long as the costs of the plan continue to be allocated among the participating employers on a per capita basis.

G. ERISA Technical Release 92-01, 57 Fed. Reg. 23272 (June 2, 1992). In this release the DOL announced the extension of its policy not to require amounts contributed to cafeteria plans to be held in trust through the end of 1993 or the date it adopts final regulations on this issue, if earlier. The release also said cafeteria plans with fewer than 100 participants would not have to file a Form 5500 (even where no trust was established based on its earlier release, ERISA Technical Release No. 88-1, and employee contributions are being used to pay benefits) and that larger plans relying on such exemption would not have to be audited until the DOL had finalized its position.

1. It is not completely clear whether the Release was intended to cover after-tax COBRA and other employee contributions to non-cafeteria plans.

It provides guidance concerning the proper reporting of a distribution of elective deferrals or a return of employee contribution to reduce excess annual additions arising from the allocation of forfeitures, a reasonable error in estimating a participant's compensation, or a reasonable error in determining the amount of elective deferrals that may be made with respect to any individual under § 415.

VIII. RECENT CASES OF INTEREST.


1. Facts. Joseph B. Shumate, Jr. was employed for over 30 years by Coleman Furniture. He was president and chairman of the Board of directors. Shumate and approximately 400 other employees were participants in the Coleman Furniture Corporation Pension Plan. The Plan was a tax and ERISA qualified defined benefit plan. Relevant to the issue presented, the Plan contained the required anti-assignment or alienation provision. §401(a)(13); ERISA §206(d)(1). When Coleman and Shumate both went under, Shumate and Patterson (his trustee in bankruptcy) both sought Shumate's $250,000 in qualified plan benefits.

2. Issue. Whether Section 541(c)(2) of the Bankruptcy Code (which excludes property of the debtor that is subject to a restriction on transfer enforceable under "applicable nonbankruptcy law") exempted Shumate's qualified plan benefit from his bankruptcy estate.

3. Held. An anti-alienation provision in a qualified pension plan constitutes a restriction on transfer enforceable under "applicable nonbankruptcy law."

a. Plain language analysis.

b. Comparison of other references in Bankruptcy Code.

4. Impact.


   (1) Keough plans covering no employees. DOL Reg. §2510.3-3(b).

   (2) Corporate plans covering only shareholder and spouse. DOL Reg. §2510.3(c).

b. IRAs/SEPs

(2) Pre-emption of state law.

(3) IRAs exempt—state law; no ERISA pre-emption.

(4) SEPs nonexempt—§401(a)(13) and ERISA §206(d)(1) inapplicable; ERISA applies state law exemption preempted.

(5) Malpractice.


1. Facts. The Sperry Plan document delegated responsibility for most plan amendments to the Employee Benefits Executive Committee. The Plan document provided that "any discretionary actions taken under the Plan by the Committee with respect to classification of employees, members, contributions or benefits shall be uniform in nature and applicable to all persons similarly situated." In conjunction with an early retirement window, the Committee delegated to the employer the right to decide who would be offered optional accelerated early retirement benefits under the Plan. Generally, management decided to offer the special early retirement incentives to employees of entities it was keeping and not to employees of entities it was planning to divest.

2. Held. The Committee's actions violated ERISA. Although the Committee could have amended the Plan to delete the language that caused the problem and essentially make the decision a "settlor function," it failed to do so. Lack of notice and failure to adhere to formalities that would allow a reasonable person to "ascertain the intended benefits" was found to be problematic. The Committee's action was found to be an improper delegation of its right to amend the Plan and a failure to prevent management from improperly construing the Plan's "uniformity rules" so long as the provisions in question existed. The court said in particular that "A more sophisticated party must, in particular, turn square corners to avoid misleading less legally knowledgeable parties relying on documents provided to them—especially where required by statute to be made available."

C. Davidson v. Canteen Corp., Nos. 97-1270 and 91-1348, 1992 U.S. App. Lexis 4680 (7th Cir.). Failure to notify participants of pension plan amendment that changed definition of compensation on which benefits accrued violates ERISA. At issue were gains pertaining to the exercise of stock options. The District Court granted the employees the benefit they would have received without regard to the plan amendment in question. The Seventh Circuit affirmed. See ERISA §204(h).

1. Note that ERISA §204(h) applies only to defined benefit and money purchase plans.
2. What about other employee pension benefit or welfare plans?

a. Is notice enough or should plan documents also be formally amended?


1. In late 1989, the Service initiated the so-called small plan actuarial audit program, which was intended to raise $666,000,000 from the sponsors of small, mostly individual defined benefit plans. Documents subsequently released under the Freedom of Information Act indicated that the money would be raised through the disallowance of 85% of the deductions claimed in small plans using interest assumptions of less than 8% and retirement age assumptions below age 65.

2. Announcement 91-92, IRB 1991-25 (6-24-91). Announcement 91-92 unveiled the Services Actuarial Resolution Program (ARP). Basically, under this program that was initially to be available from July 1, 1991, through March 31, 1992, taxpayers who accepted the Service's adjustments pertaining to the interest rate and normal retirement age assumptions under individual defined benefit plans would not be assessed certain penalties. These included: § 4972(a) (a 10% excise tax on nondeductible contributions); § 6651 (penalty for failure to file an excise tax return and pay the penalty); § 6659(a) (a penalty -- possibly 10-30% of the related income tax liability -- pertaining to significant overstatements of pension liabilities); § 6661 (a penalty relating to the substantial understatement of tax liability); and § 6662 (a penalty pertaining to use of inappropriate actuarial assumptions and methods).

a. Basically, the ARP offered a take it or leave it approach. Taxpayers who took their cases to appeals were not to get the benefit of the proposed penalty waivers.

b. The ARP was ultimately extended through July 31, 1992. See Announcement 92-34, IRB 1992-10 (3-9-92).

3. Note that although questionable from a policy standpoint, individual defined benefit plans were perfectly legal prior to 1989. Such plans were effectively eliminated by the passage of § 401(a)(26) in TRA '86 and had been terminated and rolled over to IRAs by the time the Service commenced the small plan actuarial program.

4. Although there were some differences in the statutory language applicable to plan years beginning after December 31, 1987, for the most part, the issue was whether the assumptions and factors employed by the actuary with respect to funding a
plan were reasonable in the aggregate (taking into account the experience of the plan and reasonable expectations) and which ... offered the actuary's best estimate of anticipated experience of the plan.

5. The Vinson & Elkins case involved 117 individual defined benefit plans that were funded based on interest assumptions of 5% and a normal retirement age assumption of 62. The total disallowed deductions were $7,953,115 for 1986 and $3,496,517 for 1987.

6. Thankfully, Judge Clapp had little trouble in finding that the assumptions employed in conjunction with the plans were reasonable in the aggregate and represented the actuary's best estimate of anticipated experience under the plans as required by §412(c)(3).

7. See also:
   a. Wachtell, Lipton, Rosen & Katz v. Commissioner, 1992 RIA T.C. Memo ¶ 92,392 (July 14, 1992) also upholding 5% interest assumptions and an age 55 normal retirement age.

   b. Citrus Valley Estates, Inc. v. Commissioner, 99 T.C. No. 21, CCH Dec. 48,548 (September 29, 1992), basically upholding most of the challenged actuarial assumptions as reasonable in a group of small plan sponsor defined benefit plan audit cases (the so-called Phoenix cases).

E. Wood v. Commissioner, 955 F.2d 908 (4th Cir. 1992), cert. granted, 60 U.S.L.W. 3827. Wood involved the issue of whether the transfer of non-cash property to a plan in satisfaction of a contribution obligation constitutes a "sale or exchange" for purposes of the prohibited transaction rules § 4975(c). In Wood, the transfer involved notes. The Tax Court held that transfer of unencumbered property under such circumstances did not constitute a protected transaction. The Fourth Circuit reversed and the Supreme Court granted certiorari to resolve the conflict among the circuit courts. The petitioner subsequently moved to dismiss the petition and the Court granted the motion.

F. Keystone Consolidated Industries, Inc. v. Commissioner, 951 F.2d 76 (5th Cir. 1992). Keystone involved the same issue as was presented in Wood. In upholding the Tax Court in Keystone, the Fifth Circuit concluded that the potential for abuse that the government argued was otherwise presented was adequately protected against by the imposition of an excise tax under § 4971. When the petitioner moved to dismiss Wood, the Solicitor General filed a motion for reconsideration of its earlier petition for certiorari in Keystone. The Court subsequently granted this motion, 1992 U.S. Lexis 5545.
IX. PROPOSED BENEFITS LEGISLATION

A. HEALTH CARE.

There are lots of legislative proposals in the health care area. It is no longer a question of whether legislation in this area will pass just a question of which proposal and when.


1. This bill includes provisions requiring major defense contractors to amend their pension plans to provide early retirement benefits to employees terminated while a defense contract is in effect. Basically, the bill would eliminate early commencement actuarial reductions and mandate a $500 a month supplement to the end of the first month after an individual turns 62.

   a. The provisions would apply to individuals who have attained age 55 and who have 10 years of service.

   b. A major contractor is one who had annual Defense Department contracts exceeding $100 million for 1989, 1990 and 1991.


1. Five-year averaging and the $5,000 death benefit exclusion would be deleted.

   a. Five and ten-year averaging and capital gain treatment would be preserved for the 1986 grandfathered group (generally, persons born before January 1, 1936).

2. The net unrealized appreciation ("NUA") rules would be preserved.

3. Basis recovery rules would be simplified.

4. Nongovernmental tax-exempt organizations could establish § 401(k) plans.

5. The leased employee rules would be changed from a general "historically performed" test to a "control test."

6. The § 401(h) nondiscrimination tests would be simplified and a new "safe harbor" adopted;

7. A simpler definition of highly compensated employee would be adopted.

8. The family aggregation rules would be repealed.

9. Simpler cost of living adjustment rules would be adopted.
10. There would be changes in the full funding limitation rules.

D. H.R.2. FAMILY LEAVE.

This vetoed legislation is likely to resurface.
SPECIAL TAX NOTICE REGARDING PLAN PAYMENTS

This notice contains important information you will need before you decide how to receive your benefits from ____________________________ (the "Plan").

SUMMARY

A payment from the Plan that is eligible for "rollover" can be taken in two ways. You may have all or any portion of your payment either 1) PAID IN A "DIRECT ROLLOVER" or 2) PAID TO YOU. A rollover is a payment of your Plan benefits to your individual retirement arrangement (IRA) or to another employer plan. This choice will affect the tax you owe.

If you choose a DIRECT ROLLOVER

- Your payment will not be taxed in the current year and no federal income tax will be withheld.
- Your payment will be made directly to your IRA or, if you choose, to another employer plan that accepts your rollover.
- Your payment will be taxed later when you take it out of the IRA or the employer plan.

If you choose to have your Plan benefits PAID TO YOU

- You will receive only 80% of the payment, because the Plan administrator is required to withhold 20% of the payment and send it to the IRS as federal income tax withholding to be credited against your taxes.
- Your payment will be taxed in the current year unless you roll it over. You may be able to use special tax rules that could reduce the tax you owe. However, if you receive the payment before age 59½, you also may have to pay an additional 10% tax.
- You can roll over the payment to your IRA or to another employer plan that accepts rollovers within 60 days of receiving the payment. The amount rolled over will not be taxed until you take it out of the IRA or employer plan.
- If you want to roll over 100% of the payment to an IRA or an employer plan, you must find other money to replace the 20% that was withheld. If you roll over only the 80% that you received, you will be taxed on the 20% that was withheld and that is not rolled over.

MORE INFORMATION

X. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER .................................................. 1
XI. DIRECT ROLLOVER ........................................................................................................ 2
XII. PAYMENT PAID TO YOU .............................................................................................. 2
XIII. SURVIVING SPOUSES, ALTERNATE PAYEES, AND OTHER BENEFICIARIES .......... 4

I. PAYMENTS THAT CAN AND CANNOT BE ROLLED OVER

Payments from the Plan may be "eligible rollover distributions." This means that they can be rolled over to an IRA or to another employer plan that accepts rollovers. Your Plan administrator should be able to tell you what portion of your payment is an eligible rollover distribution. The following types of payments cannot be rolled over.
Non-taxable Payments. In general, only the "taxable portion" of your payment is an eligible rollover distribution. If you have made "after-tax" employee contributions to the Plan, these contributions will be non-taxable when they are paid to you, and they cannot be rolled over. (After-tax employee contributions generally are contributions you made from your own pay that were already taxed.)

Payments Spread Over Long Periods. You cannot roll over a payment if it is part of a series of equal (or almost equal) payments that are made at least once a year and that will last for:

- your lifetime (or your life expectancy), or
- your lifetime and your beneficiary's lifetime (or life expectancies), or
- a period of ten years or more.

Required Minimum Payments. Beginning in the year you reach age 70½, a certain portion of your payment cannot be rolled over because it is a "required minimum payment" that must be paid to you.

II. DIRECT ROLLOVER

You can choose a direct rollover of all or any portion of your payment that is an "eligible rollover distribution," as described above. In a direct rollover, the eligible rollover distribution is paid directly from the Plan to an IRA or another employer plan that accepts rollovers. If you choose a direct rollover, you are not taxed on a payment until you later take it out of the IRA or the employer plan.

Direct Rollover to an IRA. You can open an IRA to receive the direct rollover. (The term "IRA," as used in this notice, includes individual retirement accounts and individual retirement annuities.) If you choose to have your payment made directly to an IRA, contact an IRA sponsor (usually a financial institution) to find out how to have your payment made in a direct rollover to an IRA at that institution. If you are unsure of how to invest your money, you can temporarily establish an IRA to receive the payment. However, in choosing an IRA, you may wish to consider whether the IRA you choose will allow you to move all or a part of your payment to another IRA at a later date, without penalties or other limitations. See IRS Publication 590, Individual Retirement Arrangements, for more information on IRAs (including limits on how often you can roll over between IRAs).

Direct Rollover to a Plan. If you are employed by a new employer that has a plan, and you want a direct rollover to that plan, ask the administrator of that plan whether it will accept your rollover. If your new employer's plan does not accept a rollover, you can choose a direct rollover to an IRA.

Direct Rollover of a Series of Payments. If you receive eligible rollover distributions that are paid in a series for less than ten years, your choice to make or not make a direct rollover for a payment will apply to all later payments in the series until you change your election. You are free to change your election for any later payment in the series.

III. PAYMENT PAID TO YOU

If you have the payment made to you, it is subject to 20% income tax withholding. The payment (and the amount withheld) is taxed in the year you receive it unless, within 60 days, you roll it (and an amount equal to the amount withheld) over to an IRA or another plan that accepts rollovers. If you do not roll it over, special tax rules may apply.

Income Tax Withholding:

Mandatory Withholding. If any portion of the payment to you is an eligible rollover distribution, the Plan is required by law to withhold 20% of that amount. This amount is sent to the IRS as income tax withholding. For example, if your eligible rollover distribution is $10,000, only $8,000 will be paid to you because the Plan must withhold $2,000 as income tax. However, when you prepare your income tax return for the year, you will report the full $10,000 as a payment from the Plan. You will report the $2,000 as tax withheld, and it will be credited against any income tax you owe for the year.

Voluntary Withholding. If any portion of your payment is not an eligible rollover distribution but is taxable, the mandatory withholding rules described above do not apply. In this case, you may elect not to have withholding apply to that portion. To elect out of withholding, ask the Plan administrator for the election form and related information.
**Sixty-Day Rollover Option.** If you have an eligible rollover distribution paid to you, you can still decide to roll over all or part of it to an IRA or another employer plan that accepts rollovers. If you decide to roll it over, you must make the rollover within 60 days after you receive the payment. The portion of your payment that is rolled over will not be taxed until you take it out of the IRA or the employer plan.

You can roll over up to 100% of the eligible rollover distribution, including an amount equal to the 20% that was withheld. If you choose to roll over 100%, you must find other money within the 60-day period to contribute to the IRA or the employer plan to replace the 20% that was withheld. On the other hand, if you roll over only the 80% that you received, you will be taxed on the 20% that was withheld.

*Example:* Your eligible rollover distribution is $10,000, and you choose to have it paid to you. You will receive $8,000, and $2,000 will be sent to the IRS as income tax withholding. Within 60 days after receiving the $8,000, you may roll over $10,000 to an IRA or employer plan. To do this, you roll over the $8,000 you received from the Plan, and you will have to find $2,000 from other sources (your savings, a loan, etc.). In this case, the $10,000 is not taxed until you take it out of the IRA or employer plan. If you roll over $10,000, when you file your income tax return you may get a refund of the $2,000 withheld.

If, on the other hand, you roll over only $8,000, the $2,000 you did not roll over is taxed in the year it was withheld. When you file your income tax return you may get a refund of part of the $2,000 withheld. (However, any refund is likely to be larger if you roll over $10,000.)

**Additional 10% Tax If You Are Under 59½.** If you receive a payment before you reach age 59½ and you do not roll it over, then, in addition to the regular income tax, you may have to pay an extra tax equal to 10% of the taxable portion of the payment. The additional 10% tax does not apply to your payment if it is (1) paid to you because you separate from service with your employer during or after the year you reach age 55, (2) paid because you retire due to disability, (3) paid to you as equal (or almost equal) payments over your life or life expectancy (or your and your beneficiary's lives or life expectancies), or (4) used to pay certain medical expenses. See IRS Form 5329 for more information on the additional 10% tax.

**Special Tax Treatment.** If your eligible rollover distribution is not rolled over, it will be taxed in the year you receive it. However, if it qualifies as a "lump sum distribution," it may be eligible for special tax treatment. A lump sum distribution is a payment, within one year, of your entire balance under the Plan (and certain other similar plans of the employer) that is payable to you because you have reached age 59½ or have separated from service with your employer (or, in the case of a self-employed individual, because you have reached age 59½ or have become disabled). For a payment to qualify as a lump sum distribution, you must have been a participant in the Plan for at least 5 years. The special tax treatment for lump sum distributions is described below.

- **Five-Year Averaging.** If you receive a lump sum distribution after you are age 59½, you may be able to make a one-time election to figure the tax on the payment by using "5-year averaging." Five-year averaging often reduces the tax you owe because it treats the payment much as if it were paid over 5 years.

- **Ten-Year Averaging If You Were Born Before January 1, 1936.** If you receive a lump sum distribution and you were born before January 1, 1936, you can make a one-time election to figure the tax on the payment by using "10-year averaging" (using 1986 tax rates) instead of 5-year averaging (using current tax rates). Like the 5-year averaging rules, 10-year averaging often reduces the tax you owe.

- **Capital Gain Treatment If You Were Born Before January 1, 1936.** In addition, if you receive a lump sum distribution and you were born before January 1, 1936, you may elect to have the part of your payment that is attributable to your pre-1974 participation in the Plan (if any) taxed as long-term capital gain at the rate of 20%.

There are other limits on the special tax treatment for lump sum distributions. For example, you can generally elect this special tax treatment only once in your lifetime, and the election applies to all lump sum distributions that you receive in that same year. If you have previously rolled over a payment from the Plan (or certain other similar plans of the employer), you cannot use this special tax treatment for later payments from the Plan. If you roll over your payment to an IRA, you will not be able to use this special tax treatment for later payments from the IRA. Also, if you roll over only a portion of your payment to an IRA, this special tax treatment is not available for the rest of the payment. Additional restrictions are described in IRS Form 4972, which has more information on lump sum distributions and how you elect the special tax treatment.
**Employer Stock or Securities.** There is a special rule for a payment from the Plan that includes employer stock (or other employer securities). To use this special rule, 1) the payment must qualify as a lump sum distribution, as described above (or would qualify except that you do not yet have 5 years of participation in the Plan), or 2) the employer stock included in the payment must be attributable to "after-tax" employee contributions, if any. Under this special rule, you may have the option of not paying tax on the "net unrealized appreciation" of the stock until you sell the stock. Net unrealized appreciation generally is the increase in the value of the employer stock while it was held by the Plan. For example, if employer stock was contributed to your Plan account when the stock was worth $1,000 but the stock was worth $1,200 when you received it, you would not have to pay tax on the $200 increase in value until you later sold the stock.

You may instead elect not to have the special rule apply to the net unrealized appreciation. In this case, your net unrealized appreciation will be taxed in the year you receive the stock, unless you roll over the stock. The stock (including any net unrealized appreciation) can be rolled over to an IRA or another employer plan either in a direct rollover or a rollover that you make yourself.

If you receive employer stock in a payment that qualifies as a lump sum distribution, the special tax treatment for lump sum distributions described above (such as 5-year averaging) also may apply. See IRS Form 4972 for additional information on these rules.

**IV. SURVIVING SPOUSES, ALTERNATIVE PAYEES, AND OTHER BENEFICIARIES**

In general, the rules summarized above that apply to payments to employees also apply to payments to surviving spouses of employees and to spouses or former spouses who are "alternate payees." You are an alternate payee if your interest in the Plan results from a "qualified domestic relations order," which is an order issued by a court, usually in connection with a divorce or legal separation. Some of the rules summarized above also apply to a deceased employee's beneficiary who is not a spouse. However, there are some exceptions for payments to surviving spouses, alternate payees, and other beneficiaries that should be mentioned.

If you are a surviving spouse, you may choose to have an eligible rollover distribution paid in a direct rollover to an IRA or paid to you. If you have the payment paid to you, you can keep it or roll it over yourself to an IRA but you cannot roll it over to an employer plan. If you are an alternate payee, you have the same choices as the employee. Thus, you can have the payment paid as a direct rollover or paid to you. If you have it paid to you, you can keep it or roll it over yourself to an IRA or to another employer plan that accepts rollovers. If you are a beneficiary other than the surviving spouse, you cannot choose a direct rollover, and you cannot roll over the payment yourself.

If you are a surviving spouse, an alternate payee, or another beneficiary, your payment is not subject to the additional 10% tax described in section III above, even if you are younger than age 59½.

If you are a surviving spouse, an alternate payee, or another beneficiary, you may be able to use the special tax treatment for lump sum distributions and the special rule for payments that include employer stock, as described in section III above. If you receive a payment because of the employee's death, you may be able to treat the payment as a lump sum distribution if the employee met the appropriate age requirements, whether or not the employee had 5 years of participation in the Plan.

**HOW TO OBTAIN ADDITIONAL INFORMATION**

This notice summarizes only the federal (not state or local) tax rules that might apply to your payment. The rules described above are complex and contain many conditions and exceptions that are not included in this notice. Therefore, you may want to consult with a professional tax advisor before you take a payment of your benefits from the Plan. Also, you can find more specific information on the tax treatment of payments from qualified retirement plans in IRS Publication 575, *Pension and Annuity Income*, and IRS Publication 590, *Individual Retirement Arrangements*. These publications are available from your local IRS office or by calling 1-800-TAX-FORMS.