



ROUNDTABLE DISCUSSION ON MAY 7, 2004 WITH IRS ON BENEFITS ISSUES

BY: GEORGE L. CHIMENTO
JUNE 24, 2004

An American Bar Association (“ABA”) committee conducted a May 7, 2004 exchange with the IRS on various benefits issues. Although these IRS views are not binding on the agency, they do shed light on murky areas. This paper is a synopsis of some of the key topics. A complete copy of the 28 page transcript is at <http://www.abanet.org/jceb/2004/qa04irs.pdf>.

Q 17. LATE AMENDMENTS FOR THE “FINAL” 401(A)(9) REGULATIONS.

We all know that IRS took the position in Rev. Proc. 2002-29 that plans must be amended to reflect the “final” regulations under IRC 401(a)(9). The deadline was the last day of the first plan year ending on or after 12/31/03. Although this was a bit objectionable, considering that most plans already incorporate 401(a)(9) by reference, many sponsors amended their plans just to go along with the drill.

The ABA asked what a sponsor should do if it missed the amendment deadline. Come on, the ABA seems to say. You just got these people for GUST and EGTRRA. Let them amend the plans now without having to pay a penalty, and big deal if they are a little late, as long as they administered the rules properly in practice. (Considering that the final 401(a)(9) regs. require smaller distributions in virtually all cases, it’s hard to imagine how a plan could have engaged in any meaningful violation of the final regulations if it was following prior guidance).

But this ABA colloquy makes clear, unfortunately, that IRS intends to be wooden and wants to collect VCP fees for late amenders. Those who don’t pay the fees, amend late, and get caught on audit will pay even more.

Abusive? Of course. But why fight it? IRS is not sympathetic, and even considers itself “generous” for not disqualifying plans with these nickel-dime document flaws. This is an area that cries for reform, but until it happens, the VCP penalty schedule appears below. There is a 50% discount if the VCP submission occurs within one year of the last date permitted for the amendment.

<u>Number of Participants/Employees</u>	<u>Fee</u>
20 or fewer	\$750.00
21 to 50	\$1,000.00
51 to 100	\$2,500.00
101 to 500	\$5,000.00
501 to 1,000	\$8,000.00
1001 to 5,000	\$15,000.00
5,001 to 10,000	\$20,000.00
Over 10,000	\$25,000.00

Q 40. PARTIAL TERMINATION MAY OCCUR EVEN IF THE NUMBER OF PERSONS WITH ACCOUNTS DOES NOT DECREASE BY A SIGNIFICANT PERCENTAGE.

IRC 411(d)(3) requires that a plan fully vest participants affected by a partial termination. A "significant" decrease in participants due to amendment or layoff is considered a partial termination, and a decrease of 20% or more will be considered "significant" in many cases. That sounds easy to calculate. But what about a 401(k) plan, where many persons do not contribute, even though technically eligible to participate? Is the calculation of the "significant" decrease based on the number of eligibles, or the number of those who actually contribute and have account balances?

IRS disagreed with the ABA, and says a significant decrease in eligibles is a partial termination. The following examples were not in the discussion, but illustrate the principles IRS described.

Example: *There are 160 eligibles, but only 70 of them defer under 401(k). A layoff results in the termination of 32 persons, 20% of the eligibles and a "significant" percentage based on the circumstances. Only one of the laid-off employees is actually deferring under 401(k). IRS would consider this to be a partial termination, and the one laid-off person in the plan who is affected by it must be fully vested.*

Example: *Same facts, but only 20 people are laid off, and assume they are all persons with account balances. Although the number of accounts is reduced by 28% (20 / 70) it is not necessarily a partial termination. On these facts, 32 is the magic number to get to 20%. This layoff affected only 12.5% of the eligibles, rather than 20%.*

Note: It will be interesting to see how a Court comes out on this one. Don't be so sure that the second example, consistent with the IRS logic, would hold up, and remember that 20% is not necessarily a bright-line test in contested proceedings.

Q 5. & Q 6. IRC 125/129 DEPENDENT CARE ACCOUNTS.

IRS showed little sympathy for working families in this session. It agreed that a placement fee to put a child on a waiting list for a daycare center should be reimbursable under a cafeteria plan, but apparently only if the child gets into the daycare center in the same calendar year.

And a parent with a chronically-ill child, who pays a fee to hold a spot in a daycare center, is not supposed to be reimbursed. The IRS says Section 129 is meant to cover expenses so that a parent can go to work. If a parent is at home caring for the sick tot, the holding fee is an ineligible expenditure.

Note: These are non-binding IRS views. A good faith interpretation that came to a different result should not be a problem in the real world, especially if covered by a counsel's letter. It's clear that the fees to the daycare center are intended to preserve the parent's ability to go to work once the child is well. The IRS should not have been "uncomfortable" with this fact situation.

Q 20. HARDSHIP DISTRIBUTIONS.

IRS reminds that 401(k) hardship distributions for college tuition may only be permitted PROSPECTIVELY under its regulations. Reimbursement for tuition expenses already incurred is not permitted.

Q 22. 5 ½ MONTH RULE FOR TAX-EXEMPT ORGANIZATION CONTRIBUTIONS.

Tax exempt employers do not file income tax returns. So if an exempt employer makes a contribution to a 403(b) plan after the plan year ends, when will the contribution be credited for purposes of IRS limits?

This is important for those exempt employers whose contributions, coupled with 403(b) or 401(k) deferrals, approach the \$41,000 limit of IRC 415. IRS refers to its 415 regulations. An employer contribution will be credited to a limitation year if the contribution is made within 5½ months of the end of the employer fiscal year in which the limitation year ends.

Note: This is not a required result. Such "late" contributions could also be designated to apply to a current limitation year.

Q 35. NO "RULE OF PARITY" FOR MOST 401(K) PLANS.

Some plans still provide that non-vested persons who leave employment will lose credit for previous service unless their years of break-in-service are the greater of (i) five, or (ii) the number of years of previous service.

What if a 401(k) plan requires 3 years of service for vesting in matching contributions, the participant leaves after 2 years, incurs 5 breaks in service, and then returns?

The IRS view is that the participant was vested in his 401(k) contributions. Therefore, even if not vested in his matching contributions, the rule of parity cannot apply because he is not a non-vested participant. The two years of previous service must be restored.

Note: It is less complicated just to restore service to returning employees anyway, and to ignore the rule of parity in 401(k) plans. Also, rules which require payback of distributions to restore credit are not affected by this IRS view and remain valid.

Q 37. BUYBACK OF SERVICE CREDIT MAY BE MADE WITH IRA “PRE-TAX” FUNDS.

Pension plans must permit returning participants to buy back their previous service credits by restoring payments received from the plan. Of course, payments often have been rolled over to IRA's. IRS confirms that a participant may transfer rolled over money to a plan to satisfy a buyback requirement. It is not necessary to use after-tax money. It is permissible to use any IRA, even if the money in it did not originate from the plan.

Q 39. CASH-OUT COMPUTATION DOES NOT HAVE TO INCLUDE LOAN BALANCE.

Most plans provide that benefits less than \$5,000 may be cashed out without employee consent on termination. Does a loan balance get taken into account? Provided that the loan is offset against the account balance prior to the cash-out, it does not. For example, an account with a \$2,500 loan account and a \$3,500 account in other investments is considered to be less than \$5,000, but only if the offset occurs before the payment is made.

Q 44. A QDRO PAYMENT MAY BE MADE TO AN EMPLOYEE.

401(k) and pension plans generally must prohibit in-service distributions to a participant. What if husband and wife both participate in the same 401(k) plan, get divorced, and a QDRO is issued? May the plan pay money from the account of one participant to another participant? IRS agrees that the QDRO takes precedence, and a plan may make a taxable, in-service payment to a participating ex-spouse.

Q1 & Q 2. DISQUALIFIED IRA'S: CONVERTING ORDINARY INCOME TO CAPITAL GAIN.

This one is fun, so I saved it for last.

We all know that when an IRA owner engages in a prohibited transaction, the penalty is not the same as with a qualified plan. With a qualified plan, a 15% excise tax is calculated based on the amount involved, but the plan remains qualified.

A prohibited transaction with an IRA, such as the owner buying an IRA asset, has different results: (i) the entire IRA loses its status as an IRA as of January 1 of that year, (ii) the owner is treated as receiving an ordinary income distribution of all IRA assets as of that January 1, and (iii) if the owner is less than age 59½, there is a 10% penalty on the IRA balance as of that January 1.

The ABA asked how the post-January 1 profit would be taxed when the assets are eventually sold.

IRS agreed that the profit (appreciation after the January 1 deemed distribution date) will be taxed as capital gains. The tax basis is the amount of the IRA at the January 1 of the year when the prohibited transaction occurred.

Isn't that interesting? An older owner who does not have to worry about the 10% early distribution penalty actually gets a free look. If IRA assets have soared in value after January 1,

he can report the January 1 value as ordinary income and pay capital gains tax on later appreciation when he eventually sells the IRA assets, provided that he engages in a prohibited transaction in that calendar year. (Engaging in a prohibited transaction is not that easy with the typical institutional IRA, but it can be done with proper guidance.)

Note: in spite of the fearsome description, there is nothing criminal about engaging in a prohibited transaction with your own IRA. It's simply a tax matter.

Take it one step further. The IRA owner does not report taxable income on the assets for the year of the prohibited transaction, perhaps because this type of IRA owner is a bit cavalier, or just plain ignorant. A few years later, at the urging of his attorney, he amends his tax return and reports the ordinary income. He pays the ordinary tax, interest, early distribution penalty, if applicable, and possibly gets assessed negligence and underpayment penalties. What about the profit on the plan assets when they are eventually sold by the IRA owner? It's still capital gain. Interesting.

CONCLUSION

The ABA interface each year with IRS is a good idea, and we owe special thanks to the unpaid ABA volunteers who coordinated this. There are 58 questions in all.

Other areas covered include ESOP's sponsored by Subchapter S corporations, 404(k) ESOP dividends, timing of top-heavy contributions, ADP/ACP testing, the inevitable 414(v) catch-up questions, joint and survivor annuity disclosure, golden parachute consent rules applicable to non-public corporate groups, HSA's, policy loans within a qualified plan, split dollar insurance, non-discriminatory rights and features, and other coverage issues.

This article reflects the opinions of the author, George L. Chimento, and does not necessarily reflect the opinion of Davis, Malm & D'Agostine, P.C. It is provided as a courtesy by Mr. Chimento and may not be relied upon as legal advice, or to avoid taxes and penalties. Distribution to promote, market, or recommend any arrangement or investment to avoid or evade taxes, including penalties, is expressly forbidden. Any communication with the author as to its contents, does not, of itself, create a lawyer-client relationship. Under the ethical rules applicable to lawyers in some jurisdictions, this may be considered advertising.

One Boston Place, Boston, Massachusetts 02108 | phone 617.367.2500 | fax 617.523.6215 | info@davismalm.com.
© 2002-2010 Davis, Malm & D'Agostine, P.C. All Rights Reserved. Attorney Advertising: Prior results do not guarantee a similar outcome. Please read our Disclaimer.