CCH-EXP, CCH Federal Tax Service, Chapter Authors

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Chapter Authors

Paul D. Callister of Callister and Callister, LC, Glendale, CA.

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CCH-EXP, CCH Federal Tax Service §C:4.00, Scope--General Qualification for All Plans

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Scope--General Qualification for All Plans

A retirement plan must meet basic requirements to become and remain qualified. The plan must be written, permanent and for the exclusive benefit of employees. The trust associated with the plan, if there is one, must be a valid written domestic trust established by the employer. In addition, the plan must prohibit the assignment and alienation of benefits, restrict withdrawal rights and provide only incidental benefits other than retirement benefits.

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CCH-EXP, CCH Federal Tax Service §C:4.20, Overview--General Qualification for All Plans

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Overview--General Qualification for All Plans

All plans must meet basic requirements to gain qualified status. Plans must be written and intended to be permanent. Plan must be for exclusive benefit of employees. If plan uses trust, trust must be valid, written and domestic. Plan must forbid assignment or alienation of trust benefits. Employees' withdrawal rights are restricted. Plan may provide incidental benefits. Plan and trust years must be adopted, and IRS approval must be obtained if they are changed.

All plans, regardless of type, must meet basic requirements to attain and keep qualified status and gain the tax benefits that come with qualified status. These requirements cover not only the initial start up of the plan, but also regulate how the plan must operate. See §C:4.40. A plan must be written (see §C:4.63) and in existence (see §C:4.61) in the tax year for which tax benefits are being sought. To be a qualified plan, the plan must be intended to be a permanent one at the time created. Early termination of the plan can lead to retroactive disqualification if the facts and circumstances indicate that the employer never intended that the plan be permanent. See §C:4.62 .

A plan is not qualified until it is communicated to the employees. Specific requirements govern the form and timing of this communication. See §C:4.80
employees and their designated beneficiaries. If by the terms of the plan, or through the operation of the plan, the employer or any nonemployee who is not a beneficiary of an employee can benefit from the plan, qualified status can be denied or revoked. See §C:4.100 .

Most qualified plans use a trust to manage their assets and to fund the plan benefits, although trusts are not the exclusive funding vehicle allowed by law. If a plan uses a trust as the funding vehicle for its benefits, additional requirements apply. The trust must be a valid, written, domestic trust and must have been established by the employer. See §C:4.120. With some exceptions, the plan of which the trust is a part must forbid the alienation, assignment or anticipation of benefits. See §C:4.140.

The right of employees to withdraw contributions or receive distributions is restricted to some degree by all qualified plans. The severity of the restrictions depends on the type of plan. See §C:4.160 . Although plans exist either to provide for retirement or to defer income, they nevertheless are allowed to provide other benefits that are incidental to their primary purpose. These include benefits such as life, health or accident insurance. There are specific restrictions as to the amount and type of benefits that can be considered incidental. See §C:4.180.

Trusts that form part of a qualified plan must adopt an accounting period, known as a trust year, that must coincide with the trust's tax year. Qualified plans must adopt an accounting period, known as a plan year. This need not coincide with the employer's tax year, but if it does not, special rules determine the deductible limit for the employer's tax year. See §C:4.201 and §C:4.202
by the IRS. Under some circumstances, approval is automatically granted. See §C:4.203 .

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CCH-EXP, CCH Federal Tax Service §C:4.40, Plan Requirements for Qualification

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Plan Requirements for Qualification--

Plan must satisfy Code, ERISA and applicable regulations to be deemed qualified. Specific plan language may be adopted from IRS-approved prototype plans, and favorable determination letter should be obtained from IRS. Plan and underlying trust must meet basic requirements to be deemed qualified. Special rules apply to government plans, church plans and plans not providing for employer contributions.

A retirement plan must satisfy requirements imposed by the Code and ERISA to be a qualified plan. See §C:4.41 for discussion of ERISA requirements. However, these requirements generally do not apply to government plans, church plans and plans not providing for contributions by the employer or the participants. See §C:4.42 .

Under the Code, a plan must meet the following basic requirements to be deemed a qualified plan:

The plan must exist.[1] See §C:4.61 for discussion of when a plan exists, §C:2.20 for discussion of requirements for defined contribution plans and §C:3.20 for discussion of requirements for defined benefit plans.

[1] Code Sec. 401(b); *Engineered Timber Sales, Inc. v Commr*, 74 TC 808, Dec. 37,089 (1980), appeal dism'd, CA-5 (1981).

The plan must be permanent.[2] See §C:4.62 .

[2] Reg. §§1.401-0(a) , 1.401-1(b)(2).

The plan must be funded.[3] See §C:11.20 .

[3] See Rev. Rul. 71-91 , 1971-1 CB 116.

Contributions to the plan must be made by the employer and/or the employees.[4] See §C:10.20 and §C:12.20 .

[4] Code Sec. 401(a)(1).

The plan must be a definite written program (see §C:4.63) that is communicated to employees (see

§C:4.80).[5]

[5] Reg. § 1.401-1(a)(2).

The plan must be established and maintained by an employer.[6] See §C:4.60 .

[6] *Id.*

The plan must be for the exclusive benefit of the employees or their beneficiaries.[7] See §C:4.100 and §C:16.81 .

[7] Code Sec. 401(a); Reg. § 1.401-1(b)(3); see Code Sec. 401(a)(10)(A).

The plan must provide for benefits and contributions that do not exceed statutory limitations.[8] See §C:13.20 .

[8] Code Secs. 401(a)(16), 410(b)(1)(B).

Beginning in 2002, the plan must not take into account the annual compensation of each employee exceeding $200,000, adjusted for inflation in years after 2002.[9] Prior to 2002, the plan could not take into account the annual compensation of each employee that exceeded $150,000, adjusted for inflation.[10] See §C:13.160 .

[9] Code Sec. 401(a)(17), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §611(c) (June 7, 2001).

[10] Code Sec. 401(a)(17), prior to amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §611(c) (June 7, 2001); Code Secs. 401(a)(3), (6), 410.

KEY RATES AND FIGURES:

The annual compensation limit under Code Sec. 401(a)(17) for 2002 is $200,000.[11] For 2000 and 2001, the inflation-adjusted limit is $170,000.[12] In 1999, the inflation-adjusted limit is $160,000.[13]

[11] Code Sec. 401(a)(17), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §611(c) (June 7, 2001); Notice 2001-84, 2001-53 I.R.B. 642.

[12] Notice 2000-66, 2000-52 I.R.B. 600; Notice 99-55, 1999-49 I.R.B. 638.

[13] Notice 98-53, 1998-46 I.R.B. 24.

- The plan must meet minimum employee coverage standards or cover employees under a methodology that does not discriminate in favor of highly compensated employees (that is, employees who own at least 5 percent of the employer, whose annual compensation is in excess of $80,000, or if elected by the employer, employees in the top 20 percent when ranked by earnings).[14] See §C:5.80 for discussion of the participation requirements.

[14] Code Secs. 401(a)(3), 410(b)(1)(B).

- The plan's provisions governing contributions and benefits cannot discriminate in favor of highly compensated employees.[15] See §C:13A.20 .

[15] Code Secs. 401(a)(4), 414(q); Temporary Reg. § 1.414(q)-1T.

CAUTION:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: Meeting the discrimination requirements for coverage and employer contributions and allocation of benefits can be complicated if the employer is a member of a controlled group, affiliated service group or leases employees [16] in which case a much larger group of employees must be considered in testing for discrimination. See §C:18.20 .

[16] Code Sec. 414(b), (c), (m), and (n) .

- In the case of a defined benefit plan, the plan must benefit no fewer than the lesser of 50 employees or the greater of 40 percent of all employees of the employer or two employees (one employee if there is only one employee).[17] In years beginning before 1997, this participation requirement applies to all plans and requires that a plan benefit no fewer than the lesser of 50 employees of the employer or 40 percent of all employees of the employer.[18]

[17] Code Sec. 401(a)(26)(A).

[18] Code Sec. 401(a)(26)(A), prior to amendment by P.L. 104-188, 104th Cong., 2d Sess., §1432(a) (Aug 20, 1996).

- The plan must contain provisions that comply with the special rules for top-heavy plans and that will take effect in any plan year in which the plan becomes top heavy. A top-heavy plan is one that primarily benefits key employees, including officers, owners and highly compensated employees.[19] See §C:8.40 .

[19] Code Secs. 401(a)(10)(B), 416.

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The plan must meet minimum vesting requirements. Top-heavy plans must comply with special vesting schedules limiting the maximum years for full vesting to six years.[20] See §C:7.40.

[20] Code Secs. 401(a)(7), 411, 416(b); Reg. § 1.411(a)-1.

The plan must provide that participants must receive benefits following a merger or consolidation with any other plan that are no smaller than the benefits they would have received if the plan had terminated immediately before the merger or consolidation.[21] See §C:15.40 .

[21] Code Sec. 401(a)(12); Reg. § 1.401(a)-12.

The plan must provide that benefits may not be assigned, alienated or anticipated.[22] See §C:4.140 .

[22] Code Sec. 401(a)(13); Reg. § 1.401(a)-13.

A defined benefit plan must meet distribution requirements and restrictions governing the commencement and duration of benefit payments.[23] See §C:4.160 for discussion of restrictions on the commencement of distributions and §C:14.20 for discussion of distribution requirements.

[23] Code Sec. 401(a)(9), (14); Reg. § 1.401(a)-14.

The plan must provide that forfeitures may not be applied to increase benefits any employee would otherwise receive.[24] See §C:7.124 .

[24] Code Sec. 401(a)(8).

The plan must generally prohibit the forfeiture of benefits that are attributable to employer contributions when an employee who has a nonforfeitable right to at least 50 percent of the accrued benefit withdraws amounts attributable to his own contributions.[25] See §C:6.20 for discussion of accrued benefits and §C:7.120 for discussion of forfeiture.

[25] Code Secs. 401(a)(19), 411.

The plan must provide for qualified preretirement survivor annuities for participants who retire under the plan or who are vested and die before the annuity's starting date unless elected otherwise by the participant and his or her spouse.[26] See §C:4.185 and §C:14.102 .

[26] Code Secs. 401(a)(11), 417.

The provision of nonretirement benefits to the employee, such as life, accident or health insurance, as well as the supplying of any death benefits that are payable to an employee's beneficiary, must be only incidental to the plan's primary purpose of distributing accumulated funds to the employee as retirement benefits or deferred compensation.[27] See §C:4.180 and §C:14.93 .

[27] Reg. § 1.401-1(b)(1); Proposed Reg. § 1.401(a)(9)-2, Q&A 1.

If integrated with the social security system, the plan cannot reduce the amount of benefits payable to retired employees because of an increase in the amount of benefits received under social security.[28] See §C:9.40.

[28] See Code Sec. 401(a)(5), (15), (l) ; Reg. §§1.401-3(e) , 1.401(a)-15 .

§C:25.20), it must meet investment diversification and independent appraiser requirements.[29] See §C:16.63 .

[29] Code Sec. 401(a)(28); see Code Sec. 4975(e)(7).

If the plan is a defined benefit plan, it must specify the actuarial assumptions used.[30] See §C:11.100.

[30] Code Sec. 401(a)(25); Rev. Rul. 79-90, 1979-1 CB 155.

The plan must meet voting requirements pertaining to participants' rights to direct voting with respect to employer securities held by the plan if it is a defined contribution plan, other than a profit-sharing plan, (see §C:2.205) that is established by an employer whose stock is not readily tradable on an established market, and if more than 10 percent of the plan's assets are securities of the employer.[31]

[31] Code Secs. 401(a)(22), 409(e).

If the plan is a defined benefit plan, its sponsor must provide security if the plan adopts an amendment that results in the plan's being underfunded such that it can meet less than 60 percent of its obligations.[32] See §C:3.49.

[32] Code Sec. 401(a)(29).

If the plan allows for elective deferrals by participants, as in CODA or 401(k) plans, it must provide that the aggregate amount of deferrals under all plans or arrangements maintained by the same employer cannot exceed statutory limitations of 401(k).[33] See §C:10.80. If the employer matches such participant elective deferrals then the plan must meet the requirements of Code Sec. 401(m).

[33] Code Sec. 401(a)(30).

The plan must provide that it will make distributions in the form of direct trustee-to-trustee transfers if the distributee of a distribution eligible to be rolled over to another plan elects this and specifies the plan to which the transfer is to be made.[34]
requirement before the first plan year beginning on or after January 1, 1994, as long as the plan is operated in accordance with this requirement and is amended retroactively.[35] See §C:14.220 .

[34] Code Sec. 401(a)(31).

[35] P.L. 102-318 , 102d Cong., 2d Sess., §523 (July 3, 1992).

For plan years beginning after 1994, a trust forming part of a pension plan that is subject to the rules on underfunded plans does not fail to be qualified merely because it ceases to make payments that a fiduciary is prohibited from making during a period that the trust has a liquidity shortfall.[36] See §C:11.143 for discussion of the liquidity rules and §C:16.180 for discussion of the rules prohibiting payments during shortfall periods. A trust forming part of a pension plan that is subject to the Pension Benefit Guaranty Corporation (PBGC) insurance plan does not fail to be qualified merely because the pension plan of which it is a part transfers benefits of missing participants to the PBGC when it terminates.[37] See §C:15.60 for the rules on transfers at termination. After December 8, 1994, a trust generally is disqualified if, while the employer is a debtor in a federal or state bankruptcy case, the plan is amended to increase its liabilities by reason of any increase in benefits, any change in the accrual of benefits or any change in the rate at which benefits become nonforfeitable under the plan, and the amendment is effective before the effective date of the employer's plan of reorganization.[38] See §C:6.183 .

[36] Code Sec. 401(a)(32).

[37] Code Sec. 401(a)(34).

[38] Code Sec. 401(a)(33).

If the plan has an underlying trust, the trust must meet the following requirements to be deemed a qualified trust:

The trust must be in writing.[39] See §C:4.121 .

[39] Rev. Rul. 69-231 , 1969-1 CB 118.

- The trust must be established by the employer for the exclusive benefit of the employees or their beneficiaries and must be valid under local law.[40] See §C:4.122.

[40] Code Sec. 401(a); Reg. § 1.401-1(a)(3)(ii), (iii) .

- The trust generally must be a domestic trust created or organized in the United States.[41] See §C:4.123.

[41] Code Sec. 401(a); Reg. §§1.401-1(a)(3)(i) , 1.401(a)-50 .

- The trust must prohibit use of any principal or income for a purpose other than for the exclusive benefit of employees or their beneficiaries.[42] See §C:4.122 .

[42] Code Sec. 401(a)(2); Reg. § 1,401-1(a)(3)(iv).

Qualification is achieved through compliance with the Code and applicable regulations, and it does not require obtaining the advance approval of the IRS. However, the IRS does make available a form of preapproval known as the favorable determination letter.

COMMENT:

> **CCH Tax Editors** note that: As a practical matter, obtaining a favorable determination letter is an absolute necessity rather than an option, because the consequences of disqualification are so drastic and because of the complexity of the underlying plan documentation. The situation is aggravated by the prohibition against incorporation by reference, a requirement that effectively forces each drafter to attempt to paraphrase the applicable Code provisions or adopt specific plan language contained in prototype plans that have been approved by the IRS.
>
> See §C:17.20 for discussion of the procedures for obtaining a favorable determination letter.

NEW DEVELOPMENTS

ESOP not qualifying plan, therefore, ESOP trust not exempt.

An employer's employee stock ownership plan (ESOP) was not a qualifying plan and, therefore, the ESOP trust was not exempt from income tax. The employer was incorporated to provide management and advisory services to a manufacturing company (MFG). The IRS determined that the employer and MFG were members of an affiliated service group and the employer produced no evidence to indicate that the determination was incorrect. Consequently, Code Sec. 410 applies as if MFG and the employer were a single entity. For the plan years at issue, fewer than 70% of the combined employees were participants in the ESOP and, therefore, the ESOP did not satisfy the minimum participation requirements. Thus, the IRS correctly revoked a favorable determination letter previously issued to the employer. Additionally, the IRS correctly determined that the trust that constituted a part of the ESOP was not exempt from income taxation for the same years.

COMMENT:

Two or more plans may sometimes be aggregated so that the number of participants benefiting in both plans may be taken into consideration when determining whether minimum participation standards have been met. However, the taxpayer in the instant case failed to produce credible evidence that the MGMT ESOP can be aggregated with the MFG ESOP for this purpose. Nor did the taxpayer produce, and the record did not contain, evidence that would support a conclusion that the MGMT ESOP would qualify for subsequent plan years.

Beals Bros. Management Corp. v Commr, Dec. 54,473(M), TC Memo. 2001-234.

IRS releases new proposed regulations relating to required minimum distributions.

The IRS has proposed new regulations that will replace its 1987 proposed regulations relating to required minimum distributions. These new proposed regulations are applicable for determining required minimum distributions for calendar years beginning on or after January 1, 2002. For purposes of determining required distributions for calendar year 2001, taxpayers may rely on either the 1987 proposed regulations or these new 2001 proposed regulations.

Under the 2001 proposed regulations, satisfaction of the minimum distribution requirements satisfies the minimum distribution incidental benefit (MDIB) requirements, and therefore the separate MDIB requirements found in question and answer A-1 of Proposed Reg. § 1.401(a)(9)-2 of the 1987 proposed regulations have no corresponding material in the 2001 proposed regulations.

Proposed Reg. § 1.401(a)(9)-1 through Proposed Reg. § 1.401(a)(9)-8, issued with Notice of Proposed

Duplication of benefits and service results in nonqualified plan.

An employer that maintained separate retirement plans for its highly compensated employees (HCEs) and non-highly compensated employees (NHCEs) caused a duplication of benefits when it amended its NHCE plan to provide annual benefits for the highly compensated employees. The duplication of benefits caused the plans to fail to satisfy the nondiscrimination requirements. Although additional benefits under the HCE plan were no longer being accrued, the previously accrued benefits were maintained for distribution under the plan's terms. All years of service for HCEs were included in the computation of accrued benefits under both plans, and benefits provided by the NHCE plan were not offset by benefits provided by the HCE plan. Thus, there was a duplication of services and benefits that discriminated in favor of the HCEs.

Rev. Rul. 99-51, 1999-50 I.R.B. 652.

Annuity contract treatment available when contract holder directs investment of premiums in publicly available securities.

The IRS has issued a revenue procedure that enumerates the circumstances under which it will treat a contract as a tax-qualified annuity or tax-sheltered annuity although the contract holder directs that contract premiums be invested in publicly available securities. The contract holder will not be treated as owning the assets associated with the contract provided that no additional federal tax liability would have been incurred if the contract holder's employer had instead paid amounts into a custodial account in an arrangement that satisfied the requirements of Code Sec. 403(b)(7)(A).

The revenue procedure is effective on November 16, 1999, with respect to all tax years. It will not be applied adversely to an issuer or holder of a contract issued before that date. Rev. Rul. 81-225 is modified.

Rev. Proc. 99-44, 1999-48 I.R.B. 598.

Employee stock ownership plan may accept transfer from charitable remainder trust.

The Taxpayer Relief Act provides that an employee stock ownership plan (ESOP) may accept contributions by a charitable remainder trust pursuant to a qualified gratuitous transfer.

COMMENT:

This provision has severely limited application since it requires, among other things, that the securities transferred previously passed from a decedent dying before January 1, 1999, to a charitable remainder annuity trust.

See §N:17.20 for discussion of charitable remainder trust and qualified gratuitous transfer. This applies to transfers made by trusts to, or for the use of, an ESOP after August 5, 1997.

Code Sec. 401(a)(1), amended by P.L. 105-34, 105th Cong., 1st Sess., §1530(c)(1) (Aug 5, 1997).

Service must clarify that reasonable conclusion concerning plan's qualification is not dependent on determination letter.

Under current law, a plan receiving a rollover contribution from another plan is not disqualified in the event the plan making the rollover distribution is not qualified at the time of the distribution, so long as the receiving plan reasonably concludes, prior to accepting the distribution, that the distributing plan is qualified. See §C:14.20 for discussion of rollovers. Regulations provide that a receiving plan can reasonably conclude that a distributing plan is qualified if, for example, the distributing plan provides a statement that it has received a favorable determination letter from the Service. See §C:17.20
Relief Act, the Service must issue guidance with respect to these regulations that will clarify that it is not necessary for the distributing plan to have a determination letter with respect to its qualified status in order for the receiving plan to reasonably conclude that the contribution is a valid rollover contribution.

P.L. 105-34, 105th Cong., 1st Sess., §1509 (Aug 5, 1997).

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CCH-EXP, CCH Federal Tax Service §C:4.41, ERISA Requirements

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ERISA Requirements --

A plan must meet the following basic substantive requirements imposed by ERISA to be deemed a qualified plan:

The plan must be established and maintained under a written instrument that provides for one or more named fiduciaries with joint or several authority to control and manage the plan's operation and administration.[43] See §C:16.41 .

[43] ERISA §402(a)(1); 29 U.S.C. §1102(a)(1).

The plan must supply a procedure for establishing and carrying out a funding policy and method that is consistent with the plan's objectives and Labor title requirements.[44] See §C:11.20 for discussion of minimum funding requirements and §C:13.40 for discussion of limitations on contributions.

[44] ERISA §402(b)(1); 29 U.S.C. §1102(b)(1).

The plan must describe procedures to allocate operative and administrative responsibilities, including responsibilities of the fiduciaries.[45] See §C:16.20 for discussion of fiduciaries and §C:17.45 for discussion of administrative responsibilities.

[45] ERISA §402(b)(2); 29 U.S.C. §1102(b)(2).

The plan must provide a procedure for amending the plan and identifying the individuals with authority to amend the plan.[46] See §C:4.62[2] .

[46] ERISA §402(b)(3); 29 U.S.C. §1102(b)(3).

The plan must specify the basis on which payments are made to and from the plan.[47]

[47] ERISA §402(b)(4); 29 U.S.C. §1102(b)(4).

The plan must establish a claims procedure.[48]

[48] ERISA §503; 29 U.S.C. §1133; DOL Reg. § 2560.503-1.

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CCH-EXP, CCH Federal Tax Service §C:4.42, Government Plans, Church Plans and Plans Not Providing for Contributions by Employers or Participants

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Government Plans, Church Plans and Plans Not Providing for Contributions by Employers or Participants --

Special qualification rules apply to government plans, church plans and some plans that do not provide for contributions by employers and/or plan participants.[49] These special qualification rules are discussed in §C:23.20 .

[49] See Code Sec. 403.

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CCH-EXP, CCH Federal Tax Service §C:4.60, Plan Must Exist, Be Permanent and Be In Writing.

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Plan Must Exist, Be Permanent and Be In Writing.--

Plan must exist in tax year for which tax advantages associated with qualified status are sought. Plan must be permanent to prevent qualified plan rules from being used improperly to offset taxable income. Qualified plan must be established under written instrument.

A retirement plan must meet formal requirements to be a qualified plan. It must exist during the tax year for which qualified status is sought, although it may meet qualification requirements retroactively. See §C:4.61 . It must be permanent rather than temporary. This requirement is intended to prevent the qualified plan rules from being used to offset taxable income rather than to provide for retirement. See §C:4.62. The plan also must be established and maintained under a written instrument. See §C:4.63.

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CCH-EXP, CCH Federal Tax Service §C:4.61, Plan Must Exist

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Plan Must Exist --

A plan must exist in the tax year for which the tax advantages associated with qualified status are sought. A qualified plan usually exists once all requirements for qualification have been satisfied. However, newly established plans are deemed to have satisfied the requirements for qualification in the tax year in which the plan otherwise would have taken effect if all requirements are subsequently satisfied within the period of time, including extensions, allowed for the employer to file that year's tax return. Plans which receive determination letters showing compliance with the Tax Reform Act of 1986 and other recent statutory law changes are entitled to delay adopting certain amendments mandated by the IRS during the period known as "extended reliance."[1] See §C:17.41[4] .

[1] Rev. Proc. 97-41, 1997-33 I.R.B. 51.

A similar rule applies for purposes of rectifying amendments that disqualify a plan.[2] However, the mere fact that a plan may be amended retroactively for purposes of qualification does not mean that the existence of a plan may be accomplished retroactively. The plan must be in existence as of the last day of the year to support the first year's deduction.[3]

[2] Code Sec. 401(b); *Engineered Timber Sales, Inc. v Commr*, 74 TC 808, Dec. 37,089 (1980), appeal dism'd, CA-5 (1981); but see *Jack R. Mendenhall Corp. v Commr*, 68 TC 676, Dec. 34,556 (1977); and *Ronald R. Pawlak, P.C. v Commr*, 69 TCM 1603, Dec. 50,408(M), TC Memo. 1995-7.

[3] Rev. Rul. 81-114, 1981-1 CB 207; Rev. Rul. 76-28, 1976-1 CB 106.

Plans created under a collective bargaining agreement between employee representatives and one or more

[4] See §C:19.40 . Thus, for example, the IRS has privately ruled that a deduction was proper when a contribution to a collectively bargained plan was made in a timely manner, although the underlying plan document was not complete or signed on the last day of the plan year.[5]

[4] Code Sec. 401(i).

[5] IRS Letter Ruling 8446027.

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CCH-EXP, CCH Federal Tax Service §C:4.62, Plan Must Be Permanent

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Plan Must Be Permanent --

A qualified plan must be permanent rather than temporary.[6] See §C:4.62[1] . A plan may be retroactively disqualified if it is terminated in the first few years of its existence and, looking at all of the surrounding facts and circumstances, including the likelihood of the employer's ability to continue contributions as provided under the plan, the IRS determines that the plan does not represent a bona fide permanent program for the exclusive benefit of employees.[7] The consequences of disqualification are discussed in §C:1.60. Amendment of the plan does not violate the permanency requirement. See §C:4.62[2]. Neither does failure to make contributions to the plan. Contributions to a profit-sharing plan need not be made every year or in the same amounts each year. However, such contributions must be "recurring and substantial."[8] For discussion of court's view toward permanency, see §C:4.62[3]

[6] Reg. § 1.401-1(b)(2).

[7] *Id.*

[8] Reg. § 1.401-1(b)(2).

PLANNING NOTE:

> **Paul D. Callister** of Callister and Callister, LC, Glendale, CA, notes that: Notwithstanding the permanency requirement, money purchase pension plans may have a zero contribution rate. [9]
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> [9] Internal IRS Memorandum from Chief Employee Plans Technical Branch to District Director, Los Angeles Key District, August 10, 1995.

The presumption that the plan is not a bona fide permanent program for the exclusive benefit of employees if it is terminated in the first few years of its existence may be overcome by demonstrating that the abandonment of the plan was due to unforeseen business necessity, or if the business is sold or transferred to a concern having a plan of its own, by showing that the successor immediately terminated the acquired business's plan after the sale or transfer and extended coverage of its own plan to the acquired business's employees.[10]

[10] Rev. Rul. 69-25, 1969-1 CB 113; Reg. § 1.401-1(b)(2) ; *R.D. Sutherland v Commr*, 78 TC 395, Dec. 38,842 (1982).

An individual's ability to withdraw money from the trust fund before retirement, death or disability could raise a question of the permanency of the plan, but a distinction must be made between pension and profit-sharing plans. Pension plans are designed primarily to provide systematically for the payment of definitely determinable benefits to the employee over a period of years, usually for life, after retirement. A profit-sharing plan, on the other hand, is designed to provide for the participation of employees and their beneficiaries in the employer's profits.[11] See §C:1.85. Accordingly, the differing purposes of pension plans and profit-sharing plans underlie the requirement that pension plans, but not profit-sharing plans, must not allow hardship withdrawals before retirement.[12] See §C:4.162.

[11] Reg. § 1.401-1(b)(1) .

[12] Rev. Rul. 56-693, 1956-2 CB 282, modified by Rev. Rul. 60-323, 1960-2 CB 148.

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CCH-EXP, CCH Federal Tax Service §C:4.62[1], Intention of Permanency

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Intention of Permanency

Permanency is a criterion imposed by Treasury Regulations and not the Code. Although the issue of permanency is usually raised at the time of termination, the relevant inquiry must focus on the employer's state of mind at the time that the plan is installed. However, the employer's state of mind at installation is determined with reference to the facts and circumstances surrounding the termination, and a business purpose for the termination, such as bankruptcy, insolvency or change in ownership in an arm's-length transaction, is usually required.[13] See §C:15.60.

[13] Rev. Rul. 69-24, 1969-1 CB 110.

Although the IRS recognizes that an employer may reserve the right to change or terminate the plan or to discontinue contributions, it also regards abandonment of the plan for any reason other than business necessity during the first few years after the plan has taken effect as evidence that it was not a bona fide plan for the exclusive benefit of the employees from its inception. The IRS is especially likely to disqualify retroactively a plan under which contributions are made only until the pensions of the participants in the prohibited group are fully funded.[14] See §C:5.20 and §C:13A.162.

[14] Reg. § 1.401-1(b)(2); see Code Secs. 401(a)(3), 410(b)(1)(B); Rev. Rul. 69-24, 1969-1 CB 110.

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[14] Reg. § 1.401-1(b)(2); see Code Secs. 401(a)(3), 410(b)(1)(B); Rev. Rul. 69-24, 1969-1 CB 110.

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CCH-EXP, CCH Federal Tax Service §C:4.62[2], Exceptions to Permanency Rule

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Exceptions to Permanency Rule

A distinction must be made between outright termination of a plan on the one hand, and alteration or amendment of the plan on the other. The permanency issue is raised only on complete termination or discontinuation of contributions, and plan sponsors are routinely given the express right in the plan document to alter, amend and/or terminate the plan. Thus, for example, a plan was accepted as permanent even though contributions were guaranteed only for the five-year period of a collective bargaining agreement.[15] See §C:19.40. Furthermore, a reversion of an initial contribution and termination of the qualified plan in the event that it is determined that the plan is not initially qualified is permitted.[16] Plan terminations are discussed in §C:15.20 .

[15] Rev. Rul. 83-83, 1983-1 CB 86.

[16] ERISA §403(c)(2)(B); 29 U.S.C. §1103(c)(2)(B); Rev. Rul. 91-4, 1991-1 CB 57.

COMMENT:

> **Paul D. Callister** of Callister and Callister, LC, Glendale, CA, notes that: The Sixth Circuit has taken a more liberal view than the IRS by ruling that a plan need not provide for recurrent contributions when the employer made an irrevocable contribution of $1,000,000 to be distributed in 10 years.[17] The Ninth Circuit found a profit-sharing plan valid even though no contributions had been made from 1947 until 1961. [18] The IRS has refused to follow the Ninth Circuit [19] and does not appear to follow the Sixth Circuit.
>
> [17] *Lincoln Electric Co. Employee's Profit-Sharing Trust*, CA-6, 51-2 USTC ¶9371, 190 F2d 326.
>
> [18] *Commr v Sherwood Swan and Co., Ltd*, CA-9, 65-2 USTC ¶9742, 352 F2d 306, aff'g, 42 TC 299, Dec. 26,773 (1964).
>
> [19] Rev. Rul. 66-251, 1961 CB 128.

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CCH-EXP, CCH Federal Tax Service §C:4.63, Plan Must Be Written

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Plan Must Be Written --

A qualified plan must be established and maintained under a written instrument.[20]

[20] ERISA §402(a)(1); 29 U.S.C. §1102(a)(1); Reg. § 1.401-1(a)(2).

The courts have been willing to recognize that some latitude may be necessary on the IRS's position that the plan must be reduced to writing by the last day of the plan year for which a deduction is taken if:

(1)

A collection of writings exists that might be construed as constituting a plan as of that last day; and

(2)

The collection of writings embodies all of the plan qualification elements that are necessary to:

(a)

notify all participants and beneficiaries of their rights, benefits and obligations, and

(b)

ensure that the plan is enforceable.[21]

[21] *Engineered Timber Sales, Inc. v Commr*, 74 TC 808, Dec. 37,089 (1980), appeal dism'd, CA-5 (1981). Compare *Dejay Stores, Inc. v R.F. Ryan*, CA-2, 56-1 USTC ¶9305, 229 F2d 867; *Tavannes Watch Co., Inc. v Commr*, CA-2, 49-2 USTC ¶9338 , 176 F2d 211; *Trenton Times Corp. v US*, DC N.J., 73-2 USTC ¶9639, 361 FSupp 222, with *Hill York Corp. v US*, DC Fla., 64-2 USTC ¶9654 .

However, the written plan requirement is not satisfied if a pension plan is unsigned and unadopted.[22] An unadopted plan is unenforceable and therefore is not considered a written plan for purposes of this rule.[23]

[22] *J.U. Fazi v Commr*, 102 TC 695, Dec. 40,849 (1994).

[23] *Id.*

State law does not control whether a valid writing exists and has been adopted. Thus, a holding by a state court that a written plan exists is not sufficient to satisfy the written plan requirement.[24]

[24] *Id.*

At least one court has gone so far as to hold that the writing does not have to be complete until two and one-half months after the close of the first year for which a deduction is sought.[25] The IRS has announced its

nonacquiescence.[26]

[25] *Hill York Corp. v US*, DC Fla., 64-2 USTC ¶9654 .

[26] Rev. Rul. 69-231, 1969-1 CB 118.

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CCH-EXP, CCH Federal Tax Service §C:4.80, Plan Must Be Communicated to Employees

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Plan Must Be Communicated to Employees--

Plan is not qualified until it is communicated to employees. Preferred method is to give each employee copy of plan, although substitute methods are permitted provided they meet certain requirements.

A plan is not a qualified plan unless and until it is communicated to the employees.[1] This requirement pertains to all affected employees, that is, those in the job classifications included as participants, but not to the classifications of employees who are excluded. For example, in a salaried-only plan, it is sufficient to communicate the plan only to the salaried employees without communicating the plan to employees who are paid on an hourly basis.[2]

[1] Reg. § 1.401-1(a)(2); Rev. Rul. 75-509, 1975-2 CB 420.

[2] Rev. Rul. 73-38, 1973-1 CB 451.

A plan that has not been formally adopted in its entirety is not a qualified plan and does not satisfy the [3] Thus, if an employer uses a prototype plan in conjunction with a joinder agreement containing specialized information that permits the prototype plan to fit the needs of the employer's specific plan, failure to adopt the joinder agreement as well as the prototype plan leaves the plan incomplete and thus fails to communicate to the employees all the information required to be communicated to them.[4]

[3] *J.U. Fazi v Commr*, 102 TC 695, Dec. 49,849 (1994).

[4] *Id.*

Communication is accomplished by giving each employee a copy of the plan or by substitute means, such as a booklet, provided it contains all of the following:

- a statement that a plan has been established that specifies the eligibility requirements, contains a synopsis of all benefits provided under the plan, indicates whether employees are to contribute to the plan and, if so, states the amount or rate of contributions, and describes the provisions for vesting;

- in the case of a money purchase pension, profit-sharing or stock bonus plan, a specification of the employer contribution formula, if any; and

- a clear statement that a copy of the complete plan may be inspected at a designated place on the company's premises during reasonable, stated times.[5]

[5] Rev. Rul. 71-90, 1971-1 CB 115; DOL Reg. § 2520.1046-1.

Although communication of a plan was held to be adequate when the taxpayer discussed the terms of a stock bonus plan with its employees and read them the plan in its entirety, even though no copy or summary of the plan was given to the employees,[6] in light of the serious consequences of plan disqualification, communication of the plan should be done in writing.[7]

[6] *Aero Rental v Commr*, 64 TC 331, Dec. 33,233 (1975).

[7] See Rev. Rul. 71-90, 1971-1 CB 115.

CAUTION:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: The Department of Labor is more stringent than the IRS in its notification requirements. For instance, it is not acceptable to merely place copies of required disclosures (such as plan summaries) in a location frequented by participants. [8]

[8] DOL Reg. § 2520.104b-1, Disclosure, 29 CFR § 2520.104b-1.

PLANNING NOTE:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: The Department of Labor has issued proposed regulations permitting dissemination of summary plan documents through electronic means such as the Internet or office intranet email provided that certain safeguards ensure actual receipt by participants and that certain safeguards ensure receipt by participants and that participants may elect to receive summaries in paper form without charge. [9]

[9] Use of Electronic Communication and Recordkeeping Technologies by Employee Pension and Welfare Benefit Plans, Proposed Rule, 64 Fed Reg. § 4505-4513 (1999) (amending DOL Reg. § 2520.104b-1(c)) (modifying the previous regulation).

The communication must take place before the end of the first plan year or the corresponding deduction is disallowed.[10]

[10] Rev. Rul. 72-509, 1972-2 CB 221.

The Taxpayer Relief Act of 1997 (P.L. 105-34
Department of Labor unless they request such filing. [11] The Department of Labor has issued proposed rules recognizing these changes. [12]

[11] P.L. 105-34, §1503.

[12] Removal of Superseded Regulations Relating to Plan Descriptions and Summary Plan Descriptions, Proposed Rule, 64 Fed. Reg. § 42791-42797 (1999) (remove and reserve DOL Reg. §§ 2520.102-1 and 2520.104a-2).

CAUTION:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: Civil penalties have been

proposed for failure to comply with a Department of Labor Request. [13]

[13] Furnishing Documents to the Secretary of Labor on Request Under ERISA Section 104(a)(6) and Assessment of Civil Penalties Under ERISA Section 502(c)(6), 64 Fed Reg. 42797-42807 (1999) (proposes DOL Reg. § 2520.104a-8.

COMMENT:

CCH Tax Editors note that: Many practitioners are of the opinion that the IRS's last-day requirement[14] has been superseded by ERISA.[15] Proponents of this position find support for their view in the fact that the specific instructions for the forms used to apply for a favorable determination letter--Form 5300, Application for Determination of Defined Benefit Plan, and Form 5301, Application for Determination of Defined Contribution Plan--referred to the 1971 ruling authorizing substitute means of notifying employees of the existence of a plan[16] but not to the controversial 1972 ruling[17] before the 1982 revisions. The specific instructions to Forms 5300 and 5301 (April 1986) no longer include this reference, because the IRS has deleted the question relating to when and in what manner the employer communicated the plan to the employees. Finally, practitioners point to the instructions to former Form 5612, the IRS's now-withdrawn format for a model profit-sharing plan, which state that the interested party notice used to inform participants of the filing of the application for a determination letter[18] satisfies the communication to employees requirement contained in the regulations. This statement tends to support those practitioners finding an implied revocation of the 1972 ruling requiring communication of the plan to employees before the end of the first plan year,[19] because a small-employer applicant may, and usually does, file the plan and give the interested party notice after the close of the tax year in which the employer adopts the plan. This interpretation also could explain why Forms 5300 and 5301 no longer ask when the employer communicated the plan but continue to ask whether the employer gave the interested party notice.

[14] Rev. Rul. 72-509, 1972-2 CB 221.

[15] ERISA §§102, 104; 29 U.S.C. §§1022, 1024.

[16] Rev. Rul. 71-90, 1971-1 CB 115.

[17] Rev. Rul. 72-509, 1972-2 CB 221.

[18] See Code Sec. 7476.

[19] Rev. Rul. 72-509, 1972-2 CB 221.

PLANNING NOTE:

CCH Tax Editors note that: The timing issue discussed above may be side-stepped if the practitioner uses the preferred office procedure of preparing the summary plan description in conjunction with the plan document. Distributing the summary plan description to plan participants on the day the employer signs the plan documents will eliminate any question regarding the post-ERISA application of the IRS's 1972 ruling requiring communication of the plan to employees before the end of the first plan year on pain of losing the corresponding deduction.[20] Summary plan descriptions are discussed in §C:17.160.

[20] *Id.*

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CCH-EXP, CCH Federal Tax Service §C:4.100, Exclusive Benefit Rule

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Exclusive Benefit Rule--

Qualified plan must be for exclusive benefit of employees and their beneficiaries. Despite this requirement, divorced spouses, dependent children, tax authorities and bankruptcy trustees may acquire rights in or to participant's interest in plan.

A qualified plan must be for the exclusive benefit of the employees or their beneficiaries.[1] Thus, the employer sponsoring the plan generally is prohibited from using the plan's funds. See §C:4.101.

[1] Code Sec. 401(a) ; ERISA §404(a)(1); 29 U.S.C. §1104(a)(1).

A plan satisfies the exclusive benefit rule if it covers, in addition to current employees, former employees and employees who are temporarily on leave as, for example, when an employee is on leave for duty in the armed forces of the United States. See §C:4.102
dependents, persons who are the natural object of an employee's bounty, and any person who is designated by the plan participant to share in the plan's benefits upon the employee's death.[2] See §C:4.103. However, qualified plans must exist primarily to supply retirement income and may not serve primarily as estate planning tools. Thus, the actual benefits passing to beneficiaries must be secondary or incidental to the retirement benefits payable to the retiring employee.[3]

[2] Reg. § 1.401-1(b)(4).

[3] Rev. Rul. 74-360, 1974-2 CB 130; Rev. Rul. 72-240 , 1972-1 CB 108.

COMMENT:

> **CCH Tax Editors** note that: This rule often requires interpretation because, at least in the non-collective bargaining area, the decision to install a plan is made exclusively by the employer, often without consultation with the employees, for some motive generally serving the employer's interests. One employer motive is the desire to attract and retain qualified people by using the tax laws to provide them with deferred compensation that grows without generating tax liability. Although this may be a goal that also coincides with the interests of employee-participants, the potential for conflict between the employer's aims and the exclusive benefit rule is inherent. See §C:16.60 .
>
> A modified exclusive benefit rule applicable to multiemployer plans is discussed in §C:18.42.

The exclusive benefit rule requires that a plan must not be designed so as to constitute a subterfuge for the distribution of profits to shareholders or owners, even though shareholder or owner-employees may also be included under the plan. Although a plan need not provide benefits for all employees and may provide benefits to officers and shareholders, the plan must not by any device whatever discriminate in eligibility requirements, contributions or benefits in favor of highly compensated employees.[4] See §C:13A.20.

[4] Reg. § 1.401-1(b)(3).

Under the exclusive benefit rule, it is fatal to a plan's qualification to include as participants those who are not employees. Thus, plan trustees or directors of a corporate employer cannot participate in the plan absent an

employment relationship with the employer.[5] In contrast, the existence of an employment relationship supports participation in a plan even when the employee has substantial income from an outside profession or occupation.[6]

[5] Rev. Rul. 69-493, 1969-2 CB 88.

[6] Rev. Rul. 69-569, 1969-2 CB 91; *cf* Reg. § 1.401-1(b)(4).

EXAMPLE:

Attorney Albertson is employed by Webster Corporation to do its legal work. Albertson is paid a stated salary by the corporation, is subject to Webster Corporation's direction and control in carrying out its work, and is an employee for all purposes, including coverage for social security and income tax withholding. Albertson also maintains a separate, private law practice. Albertson's activities in connection with the private practice are not controlled or directed by Webster Corporation. Webster Corporation's retirement plan for its employees does not fail to qualify if Albertson is a participant, provided that Albertson's contributions or benefits under the plan are based only on the amount received as a corporate employee.[7]

[7] See Rev. Rul. 69-569, 1969-2 CB 91.

Contributions to a retirement plan made on behalf of a worker treated as an employee and subsequently reclassified by the IRS as an independent contractor violate the exclusive benefit rule and can cause plan disqualification. However, the IRS cannot disqualify a plan on this basis if it has previously conceded that the plan is qualified.[8]

[8] *J.E. Lozon v Commr*, 73 TCM 2914, Dec. 52,070(M), TC Memo. 1997-250.

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CCH-EXP, CCH Federal Tax Service §C:4.101, Prohibition Against Employer's Use of Funds

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Prohibition Against Employer's Use of Funds --

An employer is generally prohibited from benefiting from a qualified plan. This includes excessive employer borrowing from plans in transactions characterized by lack of security, artificially low interest rates and delinquent payments of interest or principal[9] and using its power over investing plan assets to directly benefit itself.[10]

[9] See *Central Motor Co. v US*, CA-10, 78-2 USTC ¶9608 , 583 F2d 470; *Ma-Tran Corp. v Commr*, 70 TC 158, Dec. 35,134 (1978); *Feroleto Steel Co., Inc. v Commr*, 69 TC 97, Dec. 34,706 (1977).

[10] See Rev. Rul. 69-494, 1969-2 CB 88.

Nevertheless, some exceptions to the general prohibition against employers benefiting from a qualified plan exist. A plan is not disqualified merely because the employer also derives some incidental benefit. For example, the exclusive benefit rule does not require disqualification of a plan when the employer derives the incidental benefit of receiving a reduction in the amount of premiums that must be paid to a state unemployment compensation program because the employer maintains a plan and benefits payments from the plan may result in offsets against state-provided benefits.[11] Similarly, the exclusive benefit rule does not preclude a plan amendment allowing surplus assets to revert to a bankrupt employer after all vested benefits have been paid.[12] The Supreme Court has ruled that the surplus of an over-funded defined benefit plan, even if generated by or resulting from combined employee and employer contributions, may be used by the employer to fund early retirement benefits and new plan benefits (not consisting of employee contributions) for employees who in [13] Benefits which the employer may have received by shrinking its workforce, as a result of offering early retirement benefits funded by the surplus, are incidental and legitimate. [14]

[11] *Id.*

[12] *A. Chait v G.K. Bernstein*, DC N.J., 645 FSupp 1092, aff'd, CA-3, 835 F2d 1017; see ERISA §403; 29 U.S.C. §1103.

[13] *Hughes Aircraft Co. v S.I. Jacobson*, SCt, 525 US 432, 119 SCt 755.

[14] *Id*.

Under some circumstances, plan assets may be invested in qualified employer securities and real property without violating the exclusive benefit rule.[15] The restrictions imposed on these investments are discussed in §C:16.150 .

[15] ERISA §407(a), (b), (d); 29 U.S.C. §1107(a), (b), (d).

NEW DEVELOPMENTS

Qualified status of defined benefit plan revoked due to violation of exclusive benefit rule.

The qualified status of a professional medical corporation's defined benefit plan was revoked because it did not operate the plan for the exclusive benefit of employees. The plan's investment philosophy was aimed at making capital available to its trustee, who was the corporation's sole shareholder and the plan's only participant, rather than at providing retirement benefits. The trustee essentially used the defined benefit plan as a source of cash for his immediate personal needs rather than as a source of income for his future retirement. The plan made 13 loans to the trustee/sole shareholder over the course of several years. Although the loan documents and plan documents provided for interest at current market rates and a maximum repayment period, the shareholder never made any interest or principal payments. Eventually, 75 percent of the plan assets were in loans to the sole shareholder. These factors indicated a clear violation of the exclusive benefit rule.

Westchester Plastic Surgerical Associates, P.C. v Commr, Dec 53,616(M) , TC Memo. 1999-369.

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CCH-EXP, CCH Federal Tax Service §C:4.102, Terminated or Retired Employees

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Terminated or Retired Employees --

Plans can cover employees on leaves of absence when the leaves are temporary, as, for example, when an employee is on leave for duty in the armed forces of the United States.[16] In addition, plans may continue to credit time for participation and vesting, but not for benefit accrual, when an employee is absent on leave in accordance with the terms of an established nondiscriminatory leave policy and must provide credit for parental leave related to birth, pregnancy or adoption.[17]

[16] Reg. § 1.401-1(b)(4) .

[17] Rev. Rul. 81-106, 1981-1 CB 169; Code Sec. 410(a)(5)(E)(i) and ERISA Sec. 202(b)(5)(A); 29 U.S.C. §1052(b)(5)(A).

Contributions may continue to be made on behalf of permanently and totally disabled non-highly compensated employees who participated in defined contribution plans before the onset of the disability.[18] For this purpose, permanently and totally disabled means being unable to engage in any gainful activity by reason of any medically determinable physical or mental impairment that can be expected to result in death or that has lasted, or can be expected to last, for a continuous period of not less than 12 months.[19] If a defined contribution plan provides for the continuation of contributions on behalf of all totally and permanently disabled participants for a fixed or determinable period, and if the resulting benefits are non-forfeitable, [20] the compensation of a permanently and totally disabled participant in the plan for purposes of determining the limit on the employer's deductible contributions is the amount of compensation that would have been received by the participant for the year if he or she was paid at the rate of compensation in effect immediately before the onset of the disability. After 1996, no election is required and highly compensated employees may receive continuous coverage. However, if the plan does not provide for the continuation of contributions for a fixed or determinable period, the pre-1997 requirements apply excluding highly compensated employees and requiring election by the employer.[21]

[18] Code Sec. 415(c)(3)(C).

[19] Code Sec. 22(e)(3) .

[20] See Code Sec. 415(c)(3).

[21] Code Sec. 415(c)(3)(C) .

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CCH-EXP, CCH Federal Tax Service §C:4.103, Beneficiaries

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Beneficiaries --

For purposes of the exclusive benefit rule, beneficiaries include the employee's estate, the employee's dependents, natural objects of his bounty and any persons designated by the employee to share in the benefits of the plan after his death.[22] However, employers are entitled to take more restrictive views of who may be designated a beneficiary and may limit eligibility to an employee's estate, the employee's dependents and the natural objects of his bounty.[23]

[22] Reg. § 1.401-1(b)(4).

[23] Rev. Rul. 70-173, 1970-1 CB 87.

PLANNING NOTE:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: The eligibility of the employee's estate to be designated a beneficiary allows the employee effective, unfettered discretion as to who the ultimate beneficiary of plan benefits shall be, subject, however, to considerations of the minimum required distributions rules. See §C:14.87.

COMMENT:

CCH Tax Editors note that: Common practice is to give the employees discretion to choose the beneficiaries supported by some fail-safe provision in the plan documents to fall back on in the event any employee fails to designate a beneficiary.

EXAMPLE:

A plan may provide that if an employee fails to designate a beneficiary, the following are deemed to have been designated as beneficiaries in the order given:

(1)

the employee's spouse;

(2)

the employee's children in equal shares;

(3)

the employee's parents;

(4)

the employee's siblings in equal shares; or

(5)

the employee's estate.

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CCH-EXP, CCH Federal Tax Service §C:4.120, Trust Requirements for Qualification

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Trust Requirements for Qualification--

Trust must be written domestic trust established by employer, subject to jurisdiction of U.S. courts, if trust is used to fund plan. Qualified plans may use annuity plans, annuity contracts and/or custodial accounts instead of qualified trust.

Qualified plans generally must be funded through a qualified trust.[1] However, a custodial account, annuity contract or insurance company contract can be substituted for a trust. See §C:4.122[1] .

[1] See Code Sec. 401(a); ERISA §§402(a), 403; 29 U.S.C. §§1102(a), 1103.

If used, a qualified trust must be a valid trust under the law of the jurisdiction in which it is located.[2] It also must be in writing (see §C:4.121 §C:4.122) and domestic (see §C:4.123). In addition, it may not provide the participants with rights that effectively eliminate the trust requirement. Thus, a written instrument that allows a participant to hold an amount equal to his account balance in the plan and to invest or reinvest the amounts does not create a qualified trust because it gives the participants the right to dispose of amounts in the plan at will.[3]

[2] Reg. § 1.401-1(a)(3)(i).

[3] Rev. Rul. 89-52, 1989-1 CB 110; see Rev. Rul. 60-323, 1960-2 CB 148.

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CCH-EXP, CCH Federal Tax Service §C:4.121, Valid Written Trust

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Valid Written Trust --

A trust that forms part of a qualified pension, profit-sharing or stock bonus plan must be in writing.[4] A written trust is required both for tax purposes (see §C:4.121[1]) and for ERISA purposes (see §C:4.121[2]). The trust instrument is not required to be separate from the plan document as long as it provides for meeting all the statutory requirements and regulatory tests imposed on qualified trusts.[5] Plan requirements for qualification are discussed in §C:4.40.

[4] Rev. Rul. 69-231, 1969-1 CB 118; see Code Sec. 401(a)(2) ; Reg. § 1.401-1(a)(2).

[5] See Reg. § 1.401-1(a)(3).

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CCH-EXP, CCH Federal Tax Service §C:4.121[1], Code Requirements

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Code Requirements

All qualified plans must be in writing.[6] See §C:4.63
regulations [7] and required by the IRS. [8] The IRS recognizes the existence of a trust which is unfunded as of the last day of the plan year (even though state law often requires funding to establish a trust). Consequently, it is possible to fund a retirement trust after the last day of the plan year, if all of the other requirements for establishing a plan have been met.[9]

[6] See Reg. § 1.401-1(a)(2).

[7] Reg. § 1.401(a)(3)(iv).

[8] Rev. Rul. 69-231, 1969-1 CB 118.

[9] Rev. Rul. 81-114, 1981-1 CB 207.

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ERISA Requirements

In general, Department of Labor regulations require assets of an employee benefit plan to be held in trust by one or more trustees pursuant to a written trust instrument.[10] In addition, ERISA provisions require that the trustees be named in the trust instrument if they are not named in the plan document or appointed by a person designated as a fiduciary in the plan document.[11] See §C:4.41.

[10] DOL Reg. § 2550.403a-1(a); see ERISA §§402(a), 403; 29 U.S.C. §§1102(a), 1103; see also DOL Reg. § 2550.403b-1(a).

[11] ERISA §403(a); 29 U.S.C. §1103(a).

These ERISA requirements do not apply to a number of plans, including Keogh and H.R.10 plans which only §C:20.20), or to IRAs that qualify as custodial accounts (see §C:22.20).[12]

[12] DOL Reg. § 2510.3-3(b) and (c); ERISA §403(b)(3); 29 U.S.C. §1103(b)(3); see Code Secs. 401(f), 408(k) .

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CCH-EXP, CCH Federal Tax Service §C:4.122, Employer Must Establish Trust

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Employer Must Establish Trust --

An employer must establish or adopt the plan and underlying trust. Employers include sole proprietors and, in the case of partners, the partnership.[13] However, the requirement does not mandate designation of the employer as the party responsible for making all contributions. Thus, for example, a trust established by an employer may call for contributions only by employees. Although these employee contributions are exempted from tax if they otherwise qualify under the Code,[14] an employer may not deduct as contributions to a qualified plan contributions to a pension trust established by employees.[15]

[13] Code Sec. 401(c)(4).

[14] See Code Sec. 501(c)(18).

[15] *Times Publishing Co. v Commr*, CA-3, 50-2 USTC ¶9465, 184 F2d 376, aff'g, 13 TC 329, Dec. 17,190 (1949).

A custodial account, annuity contract or insurance company contract other than a life, health or accident, property, casualty or liability insurance contract may be substituted for the trust as the funding vehicle for a qualified plan. The custodial account or contract must be treated as a qualified trust for purposes of the qualification rules if:[16]

[16] Code Sec. 401(f); Reg. § 1.401(f)-1(b), (c).

The custodial account or contract would, except for the fact that it is not a trust, constitute a qualified trust; and

In the case of custodial accounts, the bank or another person holding the assets demonstrates to the satisfaction of the IRS that the assets will be held in accordance with the qualification requirements.

For purposes of this exception to the general qualified trust requirements, banks include federally chartered credit unions and banks supervised under state law.[17]
qualified plan rules, as is the holder of any group annuity contract.[18]

[17] Code Secs. 401(f)(2), 408(n); Reg. § 1.401(f)-1(d)(1).

[18] Code Sec. 401(f); Reg. § 1.401(f)-1(c)(1)(i).

Annuity plans, annuity contracts and custodial accounts are defined as follows for purposes of this exception:

Annuity Plans. An annuity plan is a pension plan, the assets of which are invested in the purchase of

retirement annuities or insurance contracts from an insurance company.[19] The IRS has privately ruled that these annuities cannot be transferred by the employees or their beneficiaries, except for transfers made in connection with a QDRO.[20] See §C:4.144 §C:23.20.

[19] Code Secs. 403(a)(1), 404(a)(2); Reg. §§1.404(a)-3(a) , 1.404(a)-8 .

[20] IRS Letter Ruling 8513065.

Annuity Contracts. Both pension and profit-sharing plans may invest in annuity contracts issued by insurance companies. Annuity contracts need not be held in a trust, although the holder is treated as a trustee in some respects.[21]

[21] Code Sec. 401(f); Reg. § 1.401(f)-1.

Custodial Accounts. Pension, profit-sharing and stock bonus plans may choose to deposit their assets in a custodial account with a bank or other entity. The custodial account must be valid under local law and must be created under a written contract. The person or entity holding the assets is treated as a trustee.[22]

[22] *Id.*

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CCH-EXP, CCH Federal Tax Service §C:4.123, Trust Must Be Domestic

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Trust Must Be Domestic --

A trust that forms part of a qualified pension, profit-sharing or stock bonus plan must be created or organized in the United States. Trusts under certain electing pension, profit-sharing and stock bonus plans that are created or organized in Puerto Rico are treated as trusts that are created or organized in the United States for purposes of this rule.[23]

[23] Code Sec. 401(a); Reg. § 1.401(a)-50.

COMMENT:

> **CCH Tax Editors** note that: Because protection of employee assets is one of the concerns of ERISA, it is not surprising that those assets must remain within reach of the federal judicial system.
>
> ***COMMENT:***
>
> **CCH Tax Editors** Code Sec. 7701(a)(30)(E) to provide objective criteria to determine whether a trust is a United States Trust. [24] Pursuant to this provision, regulations were issued providing guidance in determining whether a trust is treated as a United States person and therefore as a domestic trust for federal tax purposes.[25] The regulations are generally effective for taxable years ending after February 2, 1999, but may be applied by taxpayers for taxable years beginning after December 31, 1996. In addition, to the extent prescribed in regulations, a trust that was in existence on August 20, 1996, and that was treated as a United States person on August 19, 1996, [26] See §M:1.343 for discussion of determination of residence for trusts in tax years beginning before 1997.
>
> [24] The Small Business Job Protection Act of 1996, P.L. 104-188, Act §1907 (1996), as amended by the Taxpayer Relief Act of 1997, P.L. 105-34, Act §1601(i)(3) (1997).
>
> [25] Reg. § 301.7701-7.
>
> [26] The Small Business Job Protection Act of 1996, P.L. 104-188, Act §1907(a)(3) (1996), as amended by the Taxpayer Relief Act of 1997, P.L. 105-34, Act §1601(i)(3) (1997); Reg. § 301.7701-7(f).

A trust is considered a United States person if it meets the court test and the control test.[27] The court test requires that a court within the United States be able to exercise primary supervision over the administration of the trust.[28] See §M:342[1] for discussion of the court test. The control test requires that one or more United States persons have the authority to control all substantial decisions of the trust.[29] See §M:1.342[2] for discussion of the control test.

[27] Code Sec. 7701(a)(30).

[28] Reg. § 301.7701-7(d)(2)(iv).

[29] Reg. § 301.7701-7(e)(1)(i).

The regulations provide guidance on the application of the control test , including defining United States persons, substantial decisions, and control. Generally, for purposes of the control test, all persons with any power over substantial decisions of the trust, whether acting in a fiduciary capacity or not, must be counted for purposes of the control test.[30]

[30] Reg. § 301.7701-7(d).

There is a special rule for certain employee benefit trusts that are required to be created or organized in the United States and are subject to other detailed requirements for qualification under the Internal Revenue Code. These trusts are deemed to satisfy the control test, provided that United States fiduciaries control all of the substantial decisions of the trust that are made by the trustees or fiduciaries. The following types of trusts are deemed to satisfy the control test:[31]

[31] Reg. § 301.7701-7(d)(1)(iv).

(1)

a trust that is a qualified pension, profit-sharing or stock bonus plan;

(2)

a trust that is a deferred compensation plan of a state or local government or a tax-exempt organization;

(3)

a trust that is an individual retirement account;

(4)

a trust that is a SEP or SIMPLE IRA plan;

(5)

a trust that is a Roth IRA;

(6)

a trust that is a Coverdell Education Savings Account (formerly known as an education IRA);

(7)

a trust that is a voluntary employees' benefit association (VEBA);

(8)

a group trust;[32]

[32] Rev. Rul. 81-100, 1981-1 C.B. 326.

(9)

an investment trust classified as a trust under the check-the-box rules,[33] provided that the following conditions are satisfied:

[33] Reg. § 301.7701-4(c).

(a)

all trustees are U.S. persons and at least one of the trustees is a bank or a U.S. government-owned agency or U.S. government-sponsored enterprise;

(b)

all sponsors (persons who exchange investment assets for beneficial interests with a view to selling the beneficial interests) are U.S. persons; and

(c)

the beneficial interests are widely offered for sale primarily in the U.S. to U.S. persons; and

(10)

additional categories of trusts as the IRS may designate.

See §C:4.120 for discussion of qualified pension, profit-sharing or stock bonus plans, §B:5.80 for discussion of deferred compensation plan of a state or local government or a tax-exempt organization, §C:22.41 for discussion of individual retirement account, §C:21.20 for discussion of SEPs and SIMPLE IRA plans, §C:22.45 for discussion of Roth IRAs, §A:20.101 for discussion of education IRAs, §B:12.102 for discussion of VEBAs, §C:23.164 for discussion of group trusts and §H:1.61 and §I:1.61 for discussion of investment trusts classified as trusts under the check-the-box rules.

The safe harbor for employee benefit trusts and investment trusts apply for tax years ending on or after August 9, 2001. Trusts may begin to rely on these regulations for tax years beginning after December 31, 1996. Trusts that have elected to remain domestic trusts may rely on these regulations for tax years ending after August 20, 1996.[34]

[34] Reg. § 301.7707-7(e)(3).

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CCH-EXP, CCH Federal Tax Service §C:4.140, Assignment and Alienation of Benefits

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Assignment and Alienation of Benefits--

Qualified trust benefits may not be assigned, alienated or anticipated. Debtor's interest in qualified plan is exempt from creditors in bankruptcy proceeding. Courts are divided on question of whether theft or fraud exception to prohibition exists. Prohibition does not apply to QDROs.

The plan of which a qualified trust is a part must provide that benefits may not be assigned, alienated, or anticipated.[1] See §C:4.141 . However, exceptions are provided for QDROs (see §C:4.144), voluntary assignments of benefits in pay status and participant loans. See §C:4.142 . No exemption is provided for bankruptcy, and a participant's interest in a qualified plan which is subject to Title I of ERISA is excluded from the bankruptcy estate. See §C:4.143. No exemption is provided in the case of fraud or theft by the beneficiary, although alienation may be permitted when the beneficiary is the fiduciary of the trust. See §C:4.145 .

[1] Code Sec. 401(a)(13).

An assignment or alienation of benefits includes:

any arrangement that provides for the payment to the employer of plan benefits that otherwise would be paid to a participant; and

any arrangement, whether direct or indirect, revocable or irrevocable, in which a party acquires a right or interest from a participant or beneficiary enforceable against the plan to, or in, all or any part of a plan benefit payment that is or may become payable to the participant or beneficiary.[2]

[2] Reg. § 1.401(a)-13(c)(1).

An assignment or alienation of benefits does not include:

Any arrangement for the recovery of certain payments from the participant for the benefit of the plan that began within the three-year period immediately preceding the time the plan is terminated;[3]

[3] Reg. § 1.401(a)-13(c)(2)(i); ERISA §4045(b); 29 U.S.C. §1345(b).

Any arrangement to withhold federal, state or local tax from plan benefit payments;[4]

[4] Reg. § 1.401(a)-13(c)(2)(ii).

Any arrangement for the plan to recover overpayments of benefits previously made to a participant;[5]

[5] Reg. § 1.401(a)-13(c)(2)(iii); see *Francis Jungers Sole Proprietorship v Commr*, 78 TC 326, Dec. 38,829 (1982).

Any arrangement to transfer benefit rights from the plan to another plan;[6]

[6] Reg. § 1.401(a)-13(c)(2)(iv); see *Francis Jungers Sole Proprietorship v Commr*, 78 TC 326, Dec. 38,829 (1982).

Any arrangement in which a participant or beneficiary directs the plan to pay all or any portion of a plan benefit payment to a third party, including the participant's employer, if the participant may revoke the arrangement at any time, and the third party files a written acknowledgment within 90 days after the arrangement is entered into, stating that the third party has no enforceable right to any benefit payments other than those already received under the terms of the arrangement;[7] or

[7] Reg. § 1.401(a)-13(e).

Any arrangement securing participant's loans from the plan by his or her benefit. [8]

[8] Code Sec. 401(a)(3).

Any arrangement to allow benefits to be sent directly to a participant's account at a bank, savings and loan association or credit union, provided that the direct deposit does not constitute part of an assignment or alienation arrangement.[9]

[9] Reg. § 1.401(a)-13(c)(2)(v).

EXAMPLE:

Paulson, a plan participant, makes arrangements for the direct deposit of benefit payments in an account at a savings and loan association. The account is held in joint tenancy in the names of Paulson and Paulson's spouse. This arrangement is not considered part of an assignment or alienation arrangement. Thus, it is not prohibited.[10]

[10] See Reg. § 1.401(a)-13(c)(2)(v).

Blanket written acknowledgments for all participants and beneficiaries covered under the terms of an arrangement with a particular third party are sufficient to meet the written acknowledgment requirement.[11]

[11] Reg. § 1.401(a)-13(e)(2).

A surviving spouse's qualified disclaimer of plan benefits under a qualified preretirement survivor annuity is not a prohibited assignment or alienation.[12] See §N:1.100 for discussion of qualified disclaimers.

[12] G.C.M. 39858.

ERISA anti-alienation rules do not protect funds already released by the plan to the beneficiary. However, some state statutes do. [13] [14]

[13] See California Code of Civil Procedure § 704.115(d) and N.Y. Debtor and Creditor § 282.2(e).

[14] *Trucking Employees of North Jersey Welfare Fund, Inc. v R. Colville*, CA-3, 16 F3d 52.

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CCH-EXP, CCH Federal Tax Service §C:4.141, Prohibited Assignment and Alienation

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Prohibited Assignment and Alienation --

A trust is not a qualified trust unless the plan of which it is a part provides that plan benefits may not be assigned or alienated.[15] The plan must provide that benefits may not be anticipated, assigned (either at law or in equity), alienated or made subject to attachment, garnishment, levy, execution or other legal or equitable process.[16] For purposes of this rule, a waiver by an employee of an accrued plan benefit followed by the purported reversion of the benefit to the employer corporation is an impermissible alienation of a plan benefit. The transaction is considered a taxable distribution followed by the employee's contribution of the distribution to the corporation.[17] See §C:4.142 for exceptions to this general rule. Claims against a plan by non-family members generally are subject to the prohibition against assignments and alienations.[18]

[15] Code Sec. 401(a)(13).

[16] Reg. § 1.401(a)-13(b)(1).

[17] *A.E. Gallade v Commr*, 106 TC 355, Dec. 51,363 (1996).

[18] See, e.g., *General Motors Corp. v D.J. Buha*, CA-6, 623 F2d 455; *Commercial Mortgage Insurance, Inc. v Citizens National Bank of Dallas*, DC Tex., 526 FSupp 510; *National Bank of North America v IBEW Pension Funds*, SCt N.Y., 419 NYS2d 127, 69 AD2d 679; see also IRS Letter Ruling 7920005.

The anti-alienation provisions for tax purposes are not the same as those applied by the Pension Benefit Guaranty Corporation (PBGC). Thus, taxpayers cannot rely on a determination by the PBGC that a waiver of a plan benefit is a permissible alienation.[19] The only exceptions to the anti-alienation provisions for tax purposes are those provided by statute. See §C:4.142

[19] *A.E. Gallade v Commr*, 106 TC 355, Dec. 51,363 (1996).

Although the prohibition against assignment and alienation applies to the creation, assignment or recognition of a right to any benefit that is payable with respect to a participant under a domestic relations order, it does not apply to orders that are determined to be QDROs.[20] See §C:4.144 .

[20] Code Sec. 401(a)(13)(B).

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CCH-EXP, CCH Federal Tax Service §C:4.142, Permitted Assignment and Alienation

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Permitted Assignment and Alienation --

The prohibition against assignment and alienation of trust benefits is subject to the following statutory exemptions:

the exemption for QDROs (see §C:4.144);[21]

[21] Code Sec. 401(a)(13)(B).

once benefits are in pay status and provided that the voluntary assignment is not done for the purpose of defraying plan costs, the exemption allowing a participant or beneficiary to make voluntary and revocable assignments totaling no more than 10 percent of future benefit payments;[22] and

[22] Code Sec. 401(a)(13)(A); Reg. § 1.401(a)-13(d)(1).

the exemption for valid participant loans (see §C:14.340).[23]

[23] Code Sec. 401(a)(13)(A); Reg. § 1.401(a)-13(d)(2).

A plan may provide that a participant or beneficiary may assign or alienate the right to future benefit payments once the participant or beneficiary has begun receiving benefits under the plan. However, to qualify for this exception to the general rule, the plan provision must be limited to assignments or alienations satisfying the following conditions:

They must be voluntary and revocable.

They must not exceed, in the aggregate, 10 percent of any benefit payment.

They must not have the effect or be for the purpose of defraying plan administration costs.[24]

[24] Code Sec. 401(a)(13)(A); Reg. § 1.401(a)-13(d)(1).

Attachments, garnishments, levies, executions and other legal or equitable processes are not deemed voluntary assignments or alienations for this purpose.[25]

[25] Reg. § 1.401(a)-13(d)(1).

A plan also may provide for loans to a participant or a beneficiary secured by the participant's accrued nonforfeitable benefit.[26] See §C:14.340.

[26] Code Sec. 401(a)(13)(A); Reg. § 1.401(a)-13(d)(2).

A settlement of a controversy between good faith claimants to plan benefits has been held not to be a prohibited alienation of benefits. The court reasoned that there was no reason to force the claimants to proceed with litigation by refusing to permit a settlement.[27]

[27] *E.B. Stobnicki v Textron, Inc.*, CA-5, 868 F2d 1460.

In addition, the rules prohibiting assignments or alienations of trust benefits do not preclude the enforcement of federal tax levies or the collection by the United States on a judgment resulting from an unpaid tax assessment.[28] However, state tax levies are prohibited.[29]

[28] Reg. § 1.401(a)-13(b)(2); *US v A.H. Sawaf*, CA-6, 96-1 USTC ¶50,063, 74 F3d 119, aff'g an unreported District Court decision; *T. Shanbaum v US*, CA-5, 94-2 USTC ¶50,512, 32 F3d 180, aff'g, per curiam, an unreported District Court decision; see Code Sec. 6331; see also Code Sec. 6334.

[29] *Retirement Fund Trust of the Plumbing, Heating and Piping Industries of Southern California v Franchise Tax Board*, CA-9, 909 F2d 1266; see *General Motors Corp. v D.J. Buha*, CA-6, 623 F2d 455; *Northwest Airlines, Inc. v A. Roemer*, DC Minn., 603 FSupp 7.

In holding that there is no equitable exception to the anti-alienation rule in the case of theft or fraud, the Supreme Court has said that courts should not create equitable exceptions to the rule.[30] See §C:4.145 for discussion of theft or fraud.

[30] *C. Guidry v Sheet Metal Workers National Pension Fund*, SCt, 493 US 365, 110 S Ct 680.

PLANNING NOTE:

> **Paul D. Callister** of Callister and Callister, LC, Glendale, CA, notes that: It may be possible to protect plan assets from certain federal tax obligations in bankruptcy. Federal tax obligations are subject to the automatic stay provisions of the Bankruptcy Code. [31] Federal tax obligations which are otherwise dischargeable in bankruptcy (see §P:29.84
> be exempt from creditors as in J.R. Patterson v J.B. Shumate, Jr. which applied ERISA anti-alienation provisions in bankruptcy to protect retirement plan assets. [32] See §C:4.143 .
>
> [31] 11 USC §362 (1998).
>
> [32] *J.R. Patterson v J.B. Shumate, Jr.*, SCt, 504 US 753, 112 SCt 2242.

NEW DEVELOPMENTS

IRS could levy against taxpayer's right to receive future retirement benefits, but could not compel their immediate distribution.

Code Sec. 401(k) retirement plan, but it could not force the plan administrator to distribute the assets before the taxpayer chose to retire. The plan provided for normal retirement at age 65, but the taxpayer exercised his option to defer his retirement. Participants did not have a right to receive their benefits until they actually retired, at which time they could elect payment from the account in the form of an annuity or a lump sum. The IRS could not compel the plan administrator to honor a levy against the taxpayer's property by distributing the funds in his account to the IRS in a lump sum before he retired.

The fact that a tax levy reaches a retiring taxpayer's right to receive a distribution, even if the taxpayer does not elect to receive the distribution, did not mean that the IRS could compel the taxpayer to retire so that his benefits would become payable. The tax lien attached to all of the taxpayer's current rights in the plan, and the levy reached his present right to future payments even though the plan was not in pay status. Thus, the plan administrator was not required to honor the levy until the benefits become payable to the taxpayer under the terms of the plan. Once the taxpayer actually retired, the plan administrator could be compelled to pay his benefits to the IRS. Finally, the IRS noted that since the taxpayer was married, the plan provided for his benefits to be paid in the form of a joint and survivor annuity, unless waived by the taxpayer's spouse. Thus, without the spouse's consent, the IRS could levy against that annuity only, and could not compel the administrator to distribute the funds in a lump sum.

IRS Chief Counsel Advice 200032004, May 10, 2000.

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CCH-EXP, CCH Federal Tax Service §C:4.143, Bankruptcy

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Bankruptcy --

A participant's interest in a qualified plan is excluded from the bankruptcy estate.[33] The Bankruptcy Code excludes an individual's interest in a trust that is subject to restrictions on transfer under applicable provisions of nonbankruptcy law.[34] The Supreme Court held that the anti-alienation provisions required in qualified plans by ERISA are restrictions to which this provision applies.[35]

[33] *J.R. Patterson v J.B. Shumate, Jr.*, SCt, 504 US 753, 112 SCt 2242.

[34] 11 U.S.C. §541(c)(2).

[35] *J.R. Patterson v J.B. Shumate, Jr.*, SCt, 504 US 753, 112 SCt 2242.

The Court's decision resolved a conflict among the Circuits, in which the Third,[36] Fourth,[37] Sixth,[38] and Tenth[39] Circuits had ruled that interests in qualified plans were excluded under this provision, and the Fifth,[40] Eighth,[41] Ninth,[42] and Eleventh[43] Circuits had ruled that interests in qualified plans were not so excluded, although they might be excluded under other provisions. The decisions that included the interests in the bankruptcy estate left plan administrators in a difficult position, as the IRS takes the position that a qualified plan that complies with the order of a bankruptcy court to pay portions of a bankrupt participant's interest to a creditor in bankruptcy is disqualified.[44]

[36] *K.P. Velis v M. Kardanis*, CA-3, 949 F2d 78, aff'g and rev'g, *K.P. Velis*, DC N.J., 123 BR 497.

[37] *J.B. Shumate, Jr. v J.R. Patterson* *R.A. Moore*, CA-4, 907 F2d 1476, aff'g, DC S.C..

[38] *E.H. Lucas*, CA-6, 924 F2d 597, cert. denied, 500 US 959.

[39] *W.G. Harline*, CA-10, 950 F2d 669, cert. denied, 500 US 1204.

[40] *M.J. Dyke*, CA-5, 943 F2d 1435, aff'g, DC Tex., 119 BR 536; *E.W. Goff*, CA-5, 706 F2d 574.

[41] *C.W. Graham*, CA-8, 726 F2d 1268, aff'g, BC-DC Iowa, 24 BR 305.

[42] *H.D. Daniel*, CA-9, 771 F2d 1352, cert. denied, 475 US 1016.

[43] *A.D. Lichstrahl*, CA-11, 750 F2d 1488.

[44] See IRS Letter Rulings 8131020, 8829009, 8910035 , 8951067, 9011037 , 910905.

In addition to excluding employer contributions to plans, the protections afforded by ERISA's anti-alienation provisions [45] [46] and even to an employee's after-tax contributions.[47]

[45] ERISA § 206(d)(1); 29 U.S.C. §1056(d)(1).

[46] *L.C. Rueter*, CA-9, 11 F3d 850.

[47] *W.S. Conner*, CA-9, 73 F3d 258, cert denied, 519 US 817. For discussion of after-tax contributions, see the lower court ruling of the *Bankruptcy Appellate Panel*, BAP-9, 165 BR 901.

A narrow reading of *Patterson v Shumate* is that the exclusion from the bankruptcy estate results from ERISA's anti-alienation section, [48] rather than analogous sections in the Internal Revenue Code pertaining to plan qualification. [49] This section does not apply to governmental and church plans. [50] Thus, the protection is only available to plans that are subject to the ERISA Title I anti-alienation provisions. IRAs, [51] most church plans, plans established by governmental agencies, [52]
partnership such as Keogh and "HR10" plans [53]
provisions. However, other applicable state or federal law may be applied under the Bankruptcy Code to either exclude such benefits in whole or in part from the bankruptcy estate or to exempt such assets from the claims of creditors as part of the bankruptcy exemption scheme. The statutory exemption or exclusions are of three kinds:

[48] ERISA § 206(d)(1); 29 U.S.C. §1056(d)(1).

[49] Code Sec. 401(a)(13).

[50] Reg. § 1.401(a)-13(a).

[51] ERISA §201(6); 29 U.S.C. § 1051(6) (1998).

[52] ERISA § 4(b); 29 U.S.C. § 1003(b) (1998).

[53] DOL Reg. § 2510.3-3(b) and (c), Employee Benefit Plan, 29 C.F.R. § 2510.3-3(b), (c) (1999).

Exemptions found within the Bankruptcy Code
from creditors payments from retirement plans which are "payments under a stock bonus, pension, profitsharing annuity, or similar plan . . . to the extent reasonably necessary for support of the debtor and any dependent of the debtor." [54] This exemption is only available in states which have not elected to adopt their own exemption scheme. [55] The Fifth Circuit has applied this exemption to IRAs that qualify for tax deferral on earnings, even in the absence of anti-alienation provision. [56]

[54] 11 U.S.C. § 522(d)(10) (1998).

[55] 11 U.S.C. § 522(b)(1) (1998).

[56] *D.A. Carmichael*, CA-5, 100 F3d 375.

Exclusions from the Bankruptcy Estate Based upon State Law. The Bankruptcy Code excludes from the

bankruptcy estate (as opposed to exempting from creditors) certain interests in trust if under applicable state or federal law transfer of the beneficial interest is restricted. [57] Besides its application in J.R. Patterson v J.B. Shumate, which applied ERISA to this Bankruptcy provision, this provision has been used to apply state spendthrift law generally (with the analysis turning on whether the debtor could access the benefit), as well as other applicable state law restricting the transferability of interests in retirement plans or IRAs. [58]

[57] 11 U.S.C. § 541(c)(2) (1998).

[58] *V.A. Meehan*, CA-11, 102 F3d 1209 (found that GA Code ANN. § 18-4-22(a), which is not a spendthrift provision, was applicable under federal bankruptcy law).

Exemptions under State Law which are Applied under the Bankruptcy Code. In states that have elected to apply their own exemption schemes, which are then applicable under the Bankruptcy Code, [59] state law has operated to exempt beneficial interests in retirement plans from the reach of creditors. [60] For instance, New York wholly exempts certain stock bonus, pension, profit sharing and similar plans, [61] including IRAs. [62] California wholly exempts profit sharing plans and "private retirement plans" but only exempts self-employed (Keogh) plans and IRAs to the extent necessary for support. [63] In California, 403(b) retirement plans are treated as private retirement plans and are wholly protected. [64] In fact, California and New York not only exempt funds held in a retirement plan but the distributions from such plans as well. [65] Many states do not offer as broad a protection as offered in California and New York.

[59] 11 U.S.C. § 522(b)(1) (1998).

[60] *C.G. Cheng*, CA-9, 943 F2d 1114.

[61] N.Y. Debtor and Creditor § 282.2(e).

[62] *H. Dubroff*, CA-2, 97-2 USTC ¶50,533, 119 F3d 75.

[63] California Code of Civil Procedure §§ 703.140(a) and 704.115(a) and (f) (1999).

[64] *R.C. MacIntyre*, CA-9, 74 F3d 186.

[65] California Code of Civil Procedure §§ 704.115(d) (1999) and N.Y. Debtor and Creditor § 282.2(e).

The exclusion does not apply to contributions made in violation of plan terms. Thus, contributions made to a profit-sharing plan that provided that contributions would be made only out of the employer's net income would be included in the bankruptcy estate if the employer had no net income at the time the contributions were made.[66]

[66] *Bell & Beckwith*, CA-6, 5 F3d 150, cert. denied, 510 US 1114.

Unfortunately, if no exclusions or exemptions are available to protect plan benefits, the payment of benefits to a

bankruptcy trustee will be deemed by the IRS to disqualify the plan. [67]

[67] See IRS Letter Rulings 8131020, 8829009, 8910035 , 8951067, 9011037 , December 20, 1989, and 9109051, December 5, 1990.

EXAMPLE:

A California anesthesiologist, Dr. X, sets up a profit-sharing plan qualified under Code Sec. 401. Over the years, Dr. X accumulates $1,000,000 through plan contributions and investments. Dr. X has no employees and is the sole participant in his plan. Dr. X is sued for medical malpractice by the family of one of his deceased patients, who ultimately obtain a judgment in their favor. Dr. X declares bankruptcy to try to avoid paying the judgment and elects to apply exemptions in bankruptcy which are available under state law. Since Dr. X's plan has no participants other than himself, it does not fall under the anti-alienation provisions of ERISA. [68] California state law may be applied in bankruptcy but will only protect Dr. X to the extent necessary for support of himself and his dependents. [69] The attachment of assets by the bankruptcy trustee results in disqualification of the plan and adverse tax consequences to Dr. X. [70]

[68] ERISA § 201; 29 U.S.C. §1051(6) (1998) and DOL Reg. § 2510.3-3(b), (c), Employee Benefit Plan, 29 C.F.R. § 2510.3-3(b), (c) (1999).

[69] CAL. CIV. Proc. CODE §§ 703.140(a) and 704.115(a), (f) (1999).

[70] See IRS Letter Rulings 8131020, 8829009, 8910035 , 8951067, 9011037 , December 20, 1989, and 9109051, December 5, 1990.

EXAMPLE:

Same facts as above except Dr. X's profit sharing plan is sponsored by a professional corporation owned solely by him. Again, the ERISA anti-alienation provisions probably do not apply since technically Dr. X is an owner and cannot be considered an employee. However, California law, which is applied in bankruptcy, wholly excludes Dr. X's retirement plan account from the reach of his creditors,[71] even after distribution from the plan.[72]

[71] CAL. CIV. PROC. CODE §§ 703.140(a) and 704.115(a).

[72] CAL. CIV. PROC. CODE § 704.115(d) (1999).

PLANNING NOTE:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: In the event that a plan trustee or administrator of a profit-sharing or stock bonus plan is faced with a court order to distribute plan benefits to a bankruptcy trustee, such fiduciary should negotiate with the bankruptcy trustee to permit plan benefits to be distributed under a hardship provision (see §C:4.162) (which may be added by amendment) whereby the distribution is made payable to the plan participant, but sent directly to the bankruptcy trustee to be endorsed by the participant. [73] The plan trustee should also request time from the bankruptcy trustee in order to obtain a ruling from the IRS concerning whether such an arrangement violates the anti-alienation provisions of Code Sec. 401(a)(13). [74] Similar hardship provisions are available for employee contributions under a CODA plan. See §C:4.162 . In addition, certain exceptions from disqualification under the anti-alienation provisions have been made available in the Taxpayer Relief Act

of 1997 (P.L. 105-34) in instances involving crimes against the plan, civil judgements for violations of certain provisions of Title I of ERISA, and for settlement agreements with the Department of Labor and Pension Benefit Guaranty Corporation. See §C:4.145 .

[73] See IRS Letter Ruling 9109051, December 5, 1990.

[74] *Id*.

NEW DEVELOPMENTS

Bankruptcy Court reluctantly treats IRS as secured creditor in debtor's ERISA plan.

After being reversed on this issue, a Bankruptcy Court treated the IRS as a secured creditor with respect to a debtor's ERISA-governed annuity, even though ERISA-governed plans are not generally treated as part of the bankruptcy estate. The value of the IRS's secured claim is the present value of the anticipated stream of payments to be received by the debtor with respect to the annuity.

COMMENT:

The judge in this case thought the reviewing District Court was making a mistake. The judge agreed that the IRS is clearly a secured creditor with respect to annuity payments as they were made. However, he did not think a debtor's ERISA-governed plan could be used to secure an IRS lien for unpaid taxes in a bankruptcy distribution since the plan was excluded from the debtors'bankruptcy estate and therefore was not within the court's control for the purpose of determining distributions to secured creditors. He cited the recent decision of *In re B.A. Keyes*, BC-DC Va., 2000-2 USTC ¶50,747 as support.

In re J.E. McIver, Jr., BC-DC Md., 2001-1 USTC ¶50,384, on remand from an unreported District Court decision.

IRS was secured creditor for present value of debtor's pension plan payments.

The IRS can be a secured creditor in a bankruptcy proceeding with respect to payments from a debtor's ERISA-governed annuity, and the value of the secured interest is the present value of the anticipated stream of payments to be received by the debtor with respect to the annuity.

COMMENT:

Courts are split on whether the IRS can be a secured creditor in a bankruptcy proceeding by virtue of a tax lien on the debtor's ERISA-governed plan. In a non-tax case, the Supreme Court held that an ERISA plan cannot be included in the debtor's bankruptcy estate. Some courts have held that since an ERISA plan cannot be included in the estate, a federal tax lien against such a plan does not give the IRS a security interest for purposes of bankruptcy. See, e.g., *In re B.A. Keyes*, BC-DC Va., 2000-2 USTC ¶50,747. Other courts have found an exception for federal tax liens. See, e.g., *In re J.E. McIver*, BC-DC Md., 2001-1 USTC ¶50,384.

In re V.L. Jeffrey, BC-DC Pa., 2001-1 USTC ¶50,387.

Taxpayer's interest in ERISA-protected retirement plan is property of his bankruptcy estate for the benefit of the IRS.

The IRS believes that a federal tax claim against a bankrupt taxpayer is secured by the taxpayer's interest in an

ERISA-qualified plan, or any other interest subject to similar restrictions on transfers enforceable under nonbankruptcy law. ERISA's anti-alienation provisions are not enforceable against the IRS (see §C:4.142); thus, *J.R. Patterson v J.B. Shumate*, SCt, 504 US 753 (1992), discussed in the text, does not apply to tax claims against a debtor. Moreover, outside bankruptcy, the IRS would have an enforceable lien against the debtor's vested right to receive a future stream of pension income despite spendthrift provisions in the pension plans, and there is no evidence that Congress intended the intervention of bankruptcy to alter the IRS's powers as a tax creditor. Accordingly, a debtor's interest in an ERISA plan is property of the bankruptcy estate, but only for the benefit of the IRS. See §P:29.45 for a discussion of the bankruptcy estate.

IRS Chief Counsel Advice 200041029, April 11, 2000.

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CCH-EXP, CCH Federal Tax Service §C:4.144, QDROs

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QDROs --

The general anti-assignment rules apply to assignments of benefits under a domestic relations order unless the order is a QDRO.[75] See §C:4.144[1] . See §C:4.140 for discussion of the general prohibition; see §C:4.141 for discussion of prohibited assignments and alienations; see §C:4.142 for discussion of permitted assignments and alienations.

[75] Code Sec. 401(a)(13)(B).

A plan does not fail to satisfy qualification requirements[76] merely because it does not include provisions with regard to a QDRO.[77] See §C:14.120 .

[76] See Code Secs. 401(a), 403(a).

[77] Reg. § 1.401(a)-13(g)(2).

A plan is not treated as failing to satisfy general qualification requirements, the requirements for a cash or deferred arrangement (CODA), or the requirement that employer securities must be retained in a tax-credit employee stock ownership plan (ESOP) for 84 months,[78]
§C:4.144[1]) under a QDRO. See §C:2.100 for discussion of CODAs and §C:25.20 for discussion of tax-credit ESOPs. This is the case even if the plan provides for payments under a QDRO to an alternate payee before it may make payments to a participant. Thus, for example, a pension plan may pay an alternate payee even though the participant may not receive a distribution because he continues to be employed by the employer.[79] See §C:4.144[2] .

[78] See Code Secs. 401(a) , (k), 409(d).

[79] Reg. § 1.401(a)-13(g)(3).

A plan is not required to provide additional vesting or benefits because of a QDRO.[80]

[80] Reg. § 1.401(a)-13(g)(4)(iii)(A).

A plan administrator must treat a domestic relations order received by the plan before 1985 as a QDRO to the extent that payments are made under the order. Plan administrators also are authorized to treat any other orders entered before 1985 as QDROs.[81] Similarly, an alternate payee (see §C:4.144[1]) may amend a particular order to satisfy the QDRO requirements if a plan administrator does not treat the domestic relations order as being qualified.[82]

[81] P.L. 98-397, 98th Cong., 2d Sess., §303(d) (Aug 23, 1984).

[82] S Rep. No. 575, 98th Cong., 2d Sess. 23 (1984).

If an alternate payee is treated under a QDRO as having an interest in the plan benefit, including a separate account or a percentage of the participant's interest, the QDRO cannot invest the alternate payee with a greater

right to designate a beneficiary for the alternate payee's benefit amount than the participant's right.[83]

[83] Reg. § 1.401(a)-13(g)(4)(iii)(B).

When a participant's benefits are awarded to an alternate payee under a QDRO, the benefits remain benefits of the participant for purposes of applying limitations on benefits and contributions.[84] See §C:13.20 for discussion of these limitations.

[84] Reg. § 1.401(a)-13(g)(4)(iv).

The IRS provides sample language for QDROs and a discussion of issues to be considered in drafting a QDRO, designed to assist domestic relations attorneys, plan participants, spouses and former spouses of participants, and plan administrators in drafting and reviewing QDROs.[85] The sample language is designed only to assist in preparing QDROs. A domestic relations order need not incorporate the sample language to satisfy the requirements for a QDRO, and a domestic relations order that incorporates part of the sample language can omit or modify other parts. In addition, some of the sample language is not necessarily required to satisfy the requirements for a QDRO, and alternate formulations can be used.[86] Drafters who use the sample language must conform it to the terms of the retirement to which the QDRO applies, and must specify the amounts assigned and other terms of the QDRO so as to achieve an appropriate division of marital property or level of family support.[87]

[85] Notice 97-11, 1997-1 CB 379; see P.L. 104-188, 104th Cong., 2d Sess., §1457(a)(2) (Aug 20, 1996).

[86] Notice 97-11, 1997-1 CB 379.

[87] *Id.*

A plan must establish reasonable procedures for determining the qualified status of a domestic relations order and for administering distributions made under QDROs. See §C:4.144[3] .

A QDRO may provide that a former spouse shall be treated as the current spouse of a participant for all or some purposes under Code provisions requiring plans to provide qualified joint and survivor annuities and qualified preretirement survivor annuities. See §C:4.144[4] .

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CCH-EXP, CCH Federal Tax Service §C:4.144[1], QDRO Defined

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QDRO Defined

A QDRO is a domestic relations order that creates or recognizes the existence of an alternate payee's right, or that assigns to an alternate payee the right, to receive all or a portion of the benefits payable with respect to a participant under a plan.[88] A QDRO retains its status with respect to successor plans of the same employer and plans of successor employers.[89]

[88] Code Sec. 414(p)(1)(A)(i); Reg. § 1.401(a)-13(g)(1).

[89] Code Sec. 414(a).

A domestic relations order is any judgment, decree or order that is made under a particular state's domestic relations and/or community property law that relates to the provision of child support, alimony payments or marital property rights to an alternate payee. An alternate payee is a participant's spouse, former spouse, child or other dependent. As such, domestic relations orders include approvals of property settlement agreements.[90]

[90] Code Sec. 414(p)(1)(B), (8); Reg. § 1.401(a)-13(g)(1).

COMMENT:

> **CCH Tax Editors** note that: A former spouse may be treated as the participant's surviving spouse in a QDRO for purposes of joint and survivor annuities and preretirement annuities. The current spouse is not treated as a surviving spouse if the former spouse is deemed the participant's surviving spouse. In addition, if the former spouse and the participant were married for at least one year, the surviving former spouse is treated as having satisfied the one-year marriage requirement pertaining to survivor annuities.[91] See §C:4.144[2] for discussion of payments made before the participant separates from service.
>
> [91] Code Sec. 414(p)(5).

The order must clearly specify the following four facts to qualify as a QDRO:

- the name and last known mailing address of the participant and each alternate payee covered by the order;
- the amount or percentage of the participant's benefits that the plan must pay to the alternate payee or the manner in which the amount and percentage of the payments must be determined;
- the number of payments or period of time to which the order applies; and
-

each plan to which the order applies.[92]

[92] Code Sec. 414(p)(2); Reg. § 1.401(a)-13(g)(1).

An otherwise qualified domestic relations order does not lose its QDRO status for failure to state the current mailing address of the participant and the alternate payee if the plan administrator knows the address by some means independent of the order. Thus, for example, the plan administrator cannot treat the order as a non-QDRO if he knows that the alternate payee also is a participant in the plan and the plan records contain current addresses for each participant.[93] However, a final judgment is not a QDRO if, in addition to omitting the required mailing addresses, it does not state that it creates a QDRO, does not designate the former spouse as an alternate payee and does not give the number of payments or periods to which the order applies.[94] Statements in a judicial decree that the court retains jurisdiction for a future QDRO is evidence that the decree is not a QDRO. [95] Similarly, the Tax Court held that a marital settlement that stated that a former wife shall immediately receive a stated sum from the husband's share of a plan is not a QDRO because it does not create, recognize or assign rights to the spouse as an alternate payee of any pension benefits and does not specify the number of payments or the payment period.[96] However, the Tenth Circuit, overruling the Tax Court, held that a settlement can create rights for a former spouse even without using the precise language set forth in the statute and that the requirement that the stated sum be paid immediately was sufficiently precise to satisfy the statutory requirement that the order specify the number of payments or period of time to which the order applies.[97]

[93] S Rep. No. 575, 98th Cong., 2d Sess. 20 (1984).

[94] *M.D. Boudreau v US*, BC-DC Fla., 95-1 USTC ¶50,115.

[95] *Id*.

[96] *A.C. Hawkins v Commr*, 102 TC 61, Dec. 49,638 (1994), rev'd, CA-10, 96-1 USTC ¶50,316, 86 F3d 982.

[97] *A.C. Hawkins v Commr*, CA-10, 96-1 USTC ¶50,316, 86 F3d 982, rev'g, 102 TC 61, Dec. 49,638 (1994).

COMMENT:

> **CCH Tax Editors** note that: Taxpayers outside the Tenth Circuit should not assume that other jurisdictions, or the Tax Court in cases appealable to other circuits, will follow the Tenth Circuit on this point. Thus, to avoid any possible confusion, orders that are meant to be QDROs should strictly adhere to the statutory requirements and language.

Additionally, a domestic relations order must observe the following prohibitions to be deemed a QDRO:

It must not require a plan to provide any type or form of benefit, or any option, that is not otherwise provided under the plan.

It must not require payment of benefits to an alternate payee that must be paid to another alternate payee under a preexisting QDRO.[98]

[98] Code Sec. 414(p)(3).

QDROs can only attach to benefits payable to a plan participant. Thus, a domestic relations order cannot be a QDRO with respect to benefits that have already vested in a new spouse of the participant.[99]

[99] *V.M. Hopkins v AT&T Global Information Solutions Co.*, DC W. Va., 914 FSupp 1362, aff'd, CA-4, 105 F3d 153.

EXAMPLE:

John, a plan participant, divorces Martha. John remarries and names his new wife, Irma, as the beneficiary entitled to receive survivor benefits. When John retires, he begins receiving a joint and survivor annuity. Martha obtains a domestic relations order from state court ordering that she be named as the annuity's alternate payee. The order is not a QDRO with respect to the survivor benefits because QDROs can only attach to benefits payable to a plan participant and Irma is a beneficiary with a vested interest in the survivor benefits rather than a plan participant.[100]

[100] *Id.*

CAUTION:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: The division of assets in a pension and profit sharing plan pursuant to a post-nuptial marital agreement is not a QDRO and is a violation of the anti-alienation rules resulting in disqualification and taxation of plan benefits. [101]

[101] *J. Merchant v Kelly, Haglund, Garnsey & Kahn*, DC Colo., 96-1 USTC ¶50,070, 874 FSupp 300.

For tax years prior to 2002, this definition of QDROs does not apply to any plan, such as a governmental plan, to which the general prohibition against assignments and alienations[102] (see §C:4.140) does not apply.[103] However, distributions from government or church plans are treated as if made under a QDRO if they are made under a domestic relations order that creates or recognizes the existence of an alternate payee's right, or that assigns to an alternate payee the right, to receive all or a portion of the benefits payable with respect to a participant under a plan.[104] See §C:23.20 for discussion of government and church plans.

[102] Code Sec. 401(a)(13).

[103] Code Sec. 414(p)(9); see S Rep. No. 313, 99th Cong., 2d Sess. 1106 (1986).

[104] Code Sec. 414(p)(11), prior to amendment by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §635(a) (June 7, 2001).

For tax years beginning after 2001, the rules applicable to QDRO-based distributions from governmental and church plans are extended to plans for employees of state and local governments and exempt organizations (Code Sec. 457 plans). Thus, a Code Sec. 457 plan may make early distributions under a QDRO that assigns to or creates or recognizes in an alternate payee the right to receive all or a portion of the benefits payable with respect to the participant.[105] QDRO-based distributions to a spouse or former spouse are taxable to the spouse

or former spouse.[106] A plan that makes early distributions under a QDRO does not violate applicable distribution restrictions.[107] However, these changes applicable to Code Sec. 457 plans, like the rest of the Economic Growth and Tax Relief Reconciliation Act of 2001, are scheduled to sunset after December 31, 2010, and the Internal Revenue Code would thereafter be applied as if the changes had not been made.[108]

[105] Code Sec. 414(p)(11), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §635(a) (June 7, 2001).

[106] Code Sec. 414(p)(12), as redesignated by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §635(c) (June 7, 2001).

[107] Code Sec. 414(p)(10), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §635(b) (June 7, 2001).

[108] The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §901 (June 7, 2001).

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CCH-EXP, CCH Federal Tax Service §C:4.144[2], Payments Made Before Participant Separates From Service

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Payments Made Before Participant Separates From Service

Regardless of whether the participant has terminated employment or is currently entitled to payment of benefits, payment may be made to an alternate payee on or after the date on which the participant reaches his earliest retirement age.[109] The earliest retirement age is the earlier of:[110]

[109] Code Sec. 414(p)(4).

[110] Code Sec. 414(p)(4)(B); HR Rep. No. 841, 99th Cong., 2d Sess. II-858 (1986).

(1)

the date on which the participant is entitled to a distribution under the plan; or

(2)

the later of:

(a)

the date on which the participant attains age 50, or

(b)

the earliest date on which the participant could begin receiving benefits under the plan if the participant separated from service.

COMMENT:

CCH Tax Editors note that: Absent the above, the potential for inequity is created by the rule that a plan may not be required to provide any type or form of benefit or any option not otherwise provided under the plan in cases in which the nonemployed spouse dissolves his marriage with the participant.[111] This situation could occur when the participant reaches an early retirement age but decides to continue working, perhaps with a view toward denying his former spouse receipt of any benefits.

[111] See Code Sec. 414(p)(3)(A).

Thus, QDROs may require a plan to make payment of benefits to an alternate payee as if the participant had retired on the date on which the payment begins under the order. However, if the plan must make these payments, it only need take into account the present value of the benefits actually accrued and may disregard the present value of any employer subsidy for early retirement.[112] The interest rate assumption used in determining the present value of the benefits actually accrued is the interest rate specified in the plan. If no rate is specified in the plan, the interest rate is 5 percent.[113] QDROs also may require a plan to pay benefits in any form in which the benefits may be paid under the plan to the participant, except that a QDRO may not require that benefits be paid in the form of a joint and survivor annuity with respect to the alternate payee and his subsequent spouse.[114]

surviving spouse in a QDRO for purposes of joint and survivor annuities and preretirement annuities.[115] See §C:4.144[1] .

[112] Code Sec. 414(p)(4)(A)(ii).

[113] Code Sec. 414(p)(4)(A).

[114] Code Sec. 414(p)(4)(A)(iii).

[115] Code Sec. 414(p)(5).

A QDRO may require that the amount payable to an alternate payee must be recalculated so that the alternate payee also receives a share of the subsidized benefit to which the participant is entitled if the alternate payee has begun to receive benefits under the QDRO and the participant retires with subsidized early retirement benefits. The increase payable to the alternate payee following the recalculation is not a violation of the prohibition against QDROs providing for increased benefits.[116]

[116] S Rep. No. 575, 98th Cong., 2d Sess. 21 (1984); see Code Sec. 414(p)(3)(B).

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CCH-EXP, CCH Federal Tax Service §C:4.144[3], Notification and Administration Requirements

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Notification and Administration Requirements

The plan must establish reasonable procedures for determining the qualified status of a domestic relations order and for administering distributions made under QDROs.[117] Specifically, the plan must meet the following requirements:[118]

[117] Code Sec. 414(p)(6)(B).

[118] ERISA §206(d)(3); 29 U.S.C. §1056(d)(3).

The procedures must be in writing;[119]

[119]

The plan administrator must be required to give prompt notice to plan participants and to each alternate payee and their designated representatives upon receiving a domestic relations order;[120] and

[120] Code Sec. 414(p)(6); ERISA §206(d)(3)(G); 29 U.S.C. §1056(d)(3)(G).

The plan must be required to give notice as to its procedures for ascertaining whether the order is qualified.[121]

[121] Code Sec. 414(p)(6).

Amounts that may be payable if a domestic relations order is found to be qualified must be separately accounted for during the period, which may last for up to 18 months, while qualification of the domestic relations order is being determined.[122] The 18-month period begins on the date that the domestic relations order would require first payment.[123] The plan administrator must pay the segregated amounts, together with any accrued interest, to the person or persons who would have been entitled to the amounts if there had been no order, that is, the alternate payee, if the issue of whether a particular order is a QDRO is not resolved within the 18-month period or it is determined that the order is not a QDRO.[124] A determination that an order is a QDRO that takes place after the 18-month period has run is applied prospectively only.[125]

[122] Code Sec. 414(p)(7)(A).

[123] Code Sec. 414(p)(7)(E).

124 Code Sec. 414(p)(7)(C).

125 Code Sec. 414(p)(7)(D).

The alternate payee must be treated as a beneficiary for all purposes. This means that alternate payees are entitled to receive participant loans[126] (see §C:14.340
normally provided to participants, including the ability to direct the investment of plan accounts if the plan gives this power to participants.[127]

126 Code Sec. 4975(d)(1).

127 See ERISA §206(d)(3)(J); 29 U.S.C. §1056(d)(3)(J).

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CCH-EXP, CCH Federal Tax Service §C:4.144[4], Coordination With Survivor Annuity Requirements

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Coordination With Survivor Annuity Requirements

A QDRO may provide that a former spouse shall be treated as the current spouse of a participant for all or some purposes under Code provisions[128] requiring plans to provide qualified joint and survivor annuities (QJSAs) and qualified preretirement survivor annuities (QPSAs).[129] See §C:14.100 for discussion of the requirements for QJSAs and QPSAs. Moreover, a QDRO may provide that a current spouse shall not be treated as the current spouse of the participant for all or some purposes under those Code provisions, even if applicable election periods have not begun, and the current spouse waives all future rights to a QJSA or QPSA.[130]

[128] Code Secs. 401(a)(11), 417.

[129] Code Sec. 414(p)(5)(A); Reg. § 1.401(a)-13(g)(4)(i)(A).

[130] Reg. § 1.401(a)-13(g)(4)(ii).

To the extent that a former spouse is treated as the current spouse of the participant by reason of a QDRO, any current spouse is not treated as the current spouse.[131]
spouse dies before the participant's annuity starting date, then any actual current spouse of the participant is treated as the current spouse except as otherwise provided in the QDRO.[132]

[131] Reg. § 1.401(a)-13(g)(4)(i)(B)(1).

[132] Reg. § 1.401(a)-13(g)(4)(iii)(C).

EXAMPLE 1:

Adams is divorced from Buchanan, who married Coolidge after the divorce. A QDRO provides that Adams shall be treated as Buchanan's current spouse with respect to all of Buchanan's benefits under a plan. Therefore, Adams is treated as the surviving spouse under the required QJSA or QPSA unless Buchanan obtains Adams's consent to waive the right to be treated as the surviving spouse. The fact that Buchanan married Coolidge after Buchanan's divorce from Adams is disregarded.

EXAMPLE 2:

Assume the same relationships as those in the first example. A QDRO provides that Adams shall be treated as Buchanan's current spouse only with respect to benefits that accrued before their divorce. In this case, Adams is treated as the surviving spouse under the required QJSA or QPSA with respect to benefits accrued before the divorce unless Buchanan obtains Adams's consent to waive the right to be treated as the surviving spouse with respect to those benefits. Coolidge is treated as the surviving spouse with respect to benefits accrued after the divorce unless Buchanan obtains Coolidge's consent to waive the right to be treated as the surviving spouse with respect to those benefits.

EXAMPLE 3:

Assume the same relationships as those in the first example. A QDRO provides that a portion of

Buchanan's benefit, which may be identified as either a separate account or a percentage of the benefit, must be distributed to Adams. In this case, the survivor annuity requirements[133] do not apply to the part of Buchanan's benefit that is awarded to Adams. Instead, the terms of the QDRO determine how Adams's portion of Buchanan's accrued benefit is paid. Buchanan is required to obtain Coolidge's consent if Buchanan elects to waive the right to a QJSA or QPSA with respect to the remaining portion of Buchanan's benefit.[134]

[133] Code Secs. 401(a)(11), 417.

[134] Reg. § 1.401(a)-13(g)(4)(i)(B)(2).

Code provisions respecting QJSAs and QPSAs[135]
under a QDRO.[136]

[135] Code Sec. 417.

[136] Reg. § 1.401(a)-13(g)(4)(iii)(B) .

In view of the possibility that more than one individual can be treated under a QDRO as the surviving spouse, a plan may provide that the total amount to be paid in the form of a QPSA or in the form of the survivor portion or a QJSA may not exceed the amount that would be paid if there were only one surviving spouse. The QPSA or survivor portion of the QJSA, as the case may be, must be paid as an annuity based on the life of each surviving spouse to whom the benefits are payable.[137]

[137] Reg. § 1.401(a)-13(g)(4)(i)(C)(1).

When a QDRO splits the participant's accrued benefit between the participant and a former spouse, whether through assignment of a separate account or through assignment of a percentage of the benefit, the surviving spouse of the participant is entitled to a QPSA or QJSA based on the participant's accrued benefit as of the date of death or the annuity starting date, reduced by the balance of the separate account or by the percentage of the benefit that is payable to the former spouse. The computation is to be made as though the separate account or percentage had been distributed to the participant before the relevant date.[138]

[138] Reg. § 1.401(a)-13(g)(4)(i)(C)(2).

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CCH-EXP, CCH Federal Tax Service §C:4.144[5], Taxation of QDRO Distributions

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Taxation of QDRO Distributions

A QDRO meeting the requirements of the Code does not have to indicate how the tax burden will be borne as the result of payments to the alternate payee. [139]
alternate payee bear a portion of the resulting tax burden, the participant payee was not required to include the income on his return. [140] Even if the QDRO expressly provides that the taxes from the alternate payee's portion shall be borne by the participant payee upon distribution, the Internal Revenue Code attributes the income for tax purposes to the alternate payee. [141] In the event an assignment of benefits is made pursuant to a divorce decree which does not meet the requirements of a QDRO under the Code, the participant payee still bears the tax burden for any distributions made to other parties, such as his former spouse. [142]

[139] *A.C. Hawkins v Commr*, CA-10, 96-1 USTC ¶50,316, 86 F3d 982.

[140] *Id*.

[141] *K.A. Clawson*, 72 TCM 814, Dec. 51,582(M), TC Memo. 1996-446.

[142] *M.D. Boudreau v US*, BC-DC Fla., 95-1 USTC ¶50,115.

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CCH-EXP, CCH Federal Tax Service §C:4.145, Embezzlement and Unjust Enrichment

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Embezzlement and Unjust Enrichment --

The Supreme Court has held that there is no exception to the anti-alienation rules when a beneficiary is guilty of theft or fraud.[143] Some courts had allowed garnishments of benefits in this situation,[144] while others had refused to impose a theft or fraud exception.[145]

[143] *C. Guidry v Sheet Metal Workers National Pension Fund*, SCt, 493 US 365, 110 SCt 680.

[144] See, e.g., *St. Paul Fire & Marine Insurance Co. v H.R. Cox*, DC Ala., 583 FSupp 1221, aff'd, CA-11, 752 F2d 550.

[145] *Ellis National Bank of Jacksonville v Irving Trust Co.*, CA-2, 786 F2d 466; *United Metal Products Corp. v National Bank of Detroit*, CA-6, 811 F2d 297.

The Supreme Court's decision did not reach the situation in which the beneficiary is also a fiduciary of the trust.[146] In this situation, plan participants have been permitted to offset the interest of other plan participants who had breached their fiduciary duties as trustees of the plan against a judgment based on the trustees' breaches of duty to the plan.[147] These exceptions have been codified by modification of the anti-alienation provisions of the Code as a part of the Taxpayer Relief Act of 1997 (P.L. 105-34). [148] Exceptions to the anti-alienation rules are made for conviction of a crime involving the plan, civil judgments for certain violations of Title I of ERISA or pursuant to settlement agreements with the Department of Labor or Pension Benefit Guaranty Corporation. The spouse of the affected participant must either consent in writing (which is witnessed or notarized) to such assignment or likewise be subject to the judgment, settlement or court order. [149] The applicable judgement settlement or court order must expressly provide for payment from the plan. [150]

[146] See *C. Guidry v Sheet Metal Workers National Pension Fund*, SCt, 493 US 365, 110 SCt 680.

[147] *H. Crawford v La Boucherie Bernard, Ltd.*, CA-DC, 815 F2d 117, cert. denied, 484 US 943; *R.J. Coar v J. Kazimir*, CA-3, 990 F2d 1413.

[148] Code Sec. 401(a)(13)(C).

[149] Code Sec. 401(a)(13)(C)(iii).

[150] Code Sec. 401(a)(13)(C)(ii).

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CCH-EXP, CCH Federal Tax Service §C:4.160, Restrictions on Withdrawal Rights and Early Distributions From Qualified Plans

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Restrictions on Withdrawal Rights and Early Distributions From Qualified Plans--

Current employees may make withdrawals or receive early distributions from qualified plans only under limited circumstances. Requirements imposed on early distributions from defined benefit pension plans are more restrictive than those placed on profit-sharing and stock bonus plans. In addition, provisions of qualified profit-sharing or stock bonus plan may allow acceleration of deferred distribution period and permit early withdrawals on showing of hardship.

Pension plans (including both defined benefit and money purchase plans) are established and maintained by employers for the primary purpose of systematically providing for the payment of definitely determined benefits to their employees over a period of years, usually for life, after retirement. In contrast, the purpose underlying profit-sharing and stock bonus plans is to enable employees or their beneficiaries to participate in the profits of the employer's trade or business.[1]

[1] Reg. § 1.401-1; Rev. Rul. 56-693, 1956-2 CB 282, modified by Rev. Rul. 60-323, 1960-2 CB 148.

As a result, a pension plan that permits participants, before any severance of their employment or the termination of the plan, to withdraw all or a part of the funds accumulated on their behalf for a purpose other than providing an incidental benefit, for example (disability and death benefits) in times of financial need or otherwise, generally fails to meet the qualification requirements. The requirements imposed on early distributions from defined benefit pension plans (and money purchase plans for hardship withdrawals and inservice distributions) are more restrictive than those placed on profit-sharing and stock bonus plans, and the existence of a similar provision in a profit-sharing plan does not necessarily prevent qualification.[2]

[2] Rev. Rul. 56-693 , 1956-2 CB 282, modified by Rev. Rul. 60-323, 1960-2 CB 148.

The permitted methods for a current employee to obtain a distribution from a qualified profit-sharing and stock bonus plan are limited to in-service distributions (see §C:4.161), including hardship distributions (see §C:4.162), and participant loans (see §C:4.142 and §C:14.340).

See §C:14.61 for discussion of plan distributions on the attainment of a stated age or upon the prior occurrence of an event such as a layoff, illness, disability, retirement, death or other severance of employment.

NEW DEVELOPMENTS

Distributions to transferred employees allowed.

A corporation's employees were "separated from service" for purposes of making distributions from the taxpayer's Code Sec. 401(k) plan when the taxpayer transferred the employees to another employer. The taxpayer had a public contract, which it lost to a replacement contractor. The taxpayer transferred all of the equipment and employees it used in the performance of its contract to the replacement contractor. After the transfer, the transferred employees no longer performed any services for the taxpayer; the replacement contractor did not assume any portion of the assets and liabilities of the taxpayer's plan applicable to the transferred employees. Therefore, under Rev. Rul. 2000-27 there was a sufficient change in the employment status of the transferred employees to constitute a "separation from service" that permits distributions from the taxpayer's plan. The distributions from the taxpayer's plan to the transferred employees must be lump sum

distributions and the distributions must be made by the end of the second calendar year after the calendar year in which the taxpayer transferred the employees.

IRS Letter Ruling 200127053, April 12, 2001.

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CCH-EXP, CCH Federal Tax Service §C:4.161, In-Service Distributions

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In-Service Distributions --

A defined benefit pension plan loses its qualified status if it allows participant employees to withdraw some or all of the funds accumulated on their behalf, to the extent that these sums are made up of employer contributions, before either the plan or the employee's employment is terminated.[3] In cases in which employees both are obligated to make mandatory contributions and may make voluntary contributions corresponding to a set percentage of their earnings, the plan may allow employees to withdraw their voluntary contributions without losing its qualified status if:

[3] Rev. Rul. 56-693 , 1956-2 CB 282, modified by Rev. Rul. 60-323, 1960-2 CB 148.

The withdrawals do not affect the member's participation in the plan;

The withdrawals do not affect the employer's past or future contributions on the employee's behalf;

The withdrawals do not affect the basic benefits provided by both the participant's and the employer's nonwithdrawable contributions; and

No interest is allowable with respect to the contributions withdrawn either at the time of the withdrawal or in computing benefits at retirement.[4]

[4] See Rev. Rul. 60-323, 1960-2 CB 148, modifying Rev. Rul. 56-693 , 1956-2 CB 282; Rev. Rul. 57-163, 1957-1 CB 128.

EXAMPLE:

An employer establishes an employer-funded money purchase pension plan permitting participants to make limited voluntary contributions. The plan provides that withdrawals from a participant's account may be made before retirement only to meet certain educational expenses of the participant's spouse or children, but it does not impose a restriction limiting the withdrawals to amounts corresponding to the participant's contributions and earnings thereon. As a result, the plan is not qualified.[5]

[5] See Rev. Rul. 74-417, 1974-2 CB 131.

The IRS has privately ruled that an employee does not terminate employment for purposes of the prohibition of in-service distributions if he leaves the employment of a corporation that provided his services to a third party and begins to perform the same services directly for the third party.[6]

[6] IRS Letter Ruling 9443041.

A profit-sharing or stock bonus plan does not lose its qualified status if it allows participants to withdraw funds before they retire or terminate their service with the employer, provided that the withdrawal is in an amount not exceeding the sum of their voluntary contributions to the plan and earnings thereon.[7]

[7] Rev. Rul. 69-277, 1969-1 CB 116; Rev. Rul. 60-323, 1960-2 CB 148; Rev. Rul. 60-281, 1960-2 CB 146.

In profit-sharing or stock bonus plans, the employer also has a large amount of discretion with regard to permitting in-service distributions of accrued employer contributions and earnings. See §§C:2.60 and C:2.200 . However, the plan must provide a definite, predetermined formula for distributing the plan's accumulated funds after the passage of a period of time consisting of a fixed number of years no less than two years,[8] the attainment of a stated age, or upon the occurrence of a particular event.[9] For purposes of the two-year, fixed-period-of-years accumulation requirement, contributions actually must be held for a period of two years. The requirement is not met if a mere determination is made that amounts were deemed to have been contributed for the requisite two years because such a plan requirement or determination permits the withdrawal of amounts that have not been accumulated under the plan for a fixed number of years.[10]

[8] Rev. Rul. 73-553, 1973-2 CB 130; Rev. Rul. 71-295, 1971-2 CB 184.

[9] Reg. § 1.401-1(b)(1)(ii).

[10] Rev. Rul. 73-553, 1973-2 CB 130; Rev. Rul. 71-295, 1971-2 CB 184.

EXAMPLE:

A plan would not be a qualified plan if it allowed the withdrawal in January of Year 4 (provided that the necessary election had been made in November of Year 3) of amounts contributed to the plan in March of Year 2 that were credited for Year 1.

However, an employees' profit-sharing plan does not lose its qualified status solely because it contains a provision that allows members with no less than some significant period of participation, such as a period of at least 60 months, to withdraw all employer contributions, including those that have been made in the last 24 months.[11]

[11] Rev. Rul. 68-24 , 1968-1 CB 150.

Employer discretion is more limited if the profit-sharing plan conditions the employer's contribution on that of the employee. If this is the case, the employee is deemed to have too much manipulative power over the allocation in contravention of the definite, predetermined allocation formula requirement[12] if he can make a withdrawal of the employee contribution within two years.[13] Accordingly, it is considered necessary for the employee to suffer some substantial penalty for making the withdrawal, such as a six-month suspension of employer and/or employee contributions made on the participant's behalf.[14]

[12] See Reg. § 1.401-1(b)(1)(ii).

[13] Rev. Rul. 72-367 , 1972-2 CB 219.

[14] See, eg, Rev. Rul. 74-56, 1974-1 CB 90; Rev. Rul. 72-367, 1972-2 CB 219.

EXAMPLE:

An employer has a profit-sharing plan under which it contributes out of profits an amount equal to each participant's required and voluntary contributions. A plan provision allows a participant to withdraw his own contributions at any time without penalty, and without affecting the employer contributions and earnings allocated to the participant's account. Employer contributions can be withdrawn only after termination of the participant's employment. Allowing employer contributions to be allocated on the basis of employee contributions that may be withdrawn immediately may result in manipulation of the allocation in contravention of the definite predetermined allocation formula. As a result, the plan is not a qualified plan.[15]

[15] Rev. Rul. 74-55, 1974-1 CB 89.

A pension or profit-sharing plan fails to be a qualified plan if, under the plan, any part of a participant's accrued benefit derived from the employer contributions is forfeitable solely because the participant voluntarily withdraws employee contributions after becoming a 50-percent vested participant.[16] Employer contributions may be forfeited for withdrawals of employee contributions by participants who are not 50-percent vested, but only if plan provisions permit the forfeited benefit to be restored if the participant repays the amount of the withdrawal within a specified period. For defined benefit plans, interest also must be repaid.[17] See §C:7.121 .

[16] Code Secs. 401(a)(19), 411(a)(3)(D); Reg. § 1.401(a)-19(b).

[17] Code Sec. 411(a)(3)(D)(ii).

Amounts held by a cash or deferred arrangement (CODA) may not be distributed to a participant or a beneficiary before one of the following events occurs:[18]

[18] Code Sec. 401(k)(2)(B)(i).

(1)

The employee undergoes a "separation from service" (after 2001, a "severance from employment"), becomes disabled, or dies.[19]

[19] Code Sec. 401(k)(2)(B)(i)(I), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

(2)

The plan is terminated without the establishment or maintenance of another defined contribution plan other than an employee stock ownership plan (ESOP).[20]

[20] Code Sec. 401(k)(10)(A)(i); see Code Sec. 4975(e)(7).

(3)

Before 2002, the corporation sells substantially all of the assets[21] used by the corporation in its trade or business, but only with respect to an employee who continues employment with the corporation acquiring the assets.[22]

[21] See Code Sec. 409(d)(2).

[22] Code Sec. 401(k)(10)(A)(ii), prior to repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

(4)

Before 2002, the corporation disposes of its interest in a subsidiary,[23] but only with respect to an employee who continues employment with the subsidiary.[24]

[23] See Code Sec. 409(d)(3).

[24] Code Sec. 401(k)(10)(A)(iii), prior to repeal by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

(5)

In the case of a profit-sharing or stock bonus plan, the employee attains the age of 59 1/2.

(6)

In the case of a qualified CODA, the employee suffers financial hardship.[25] See §C:4.162 .

[25] S Rep. No. 313, 99th Cong., 2d Sess. 557 (1986).

In the case of a plan termination, or the sale before 2002 of the assets or stock of the business employing the employees, the distributions must be made in a lump sum[26] by reason of the event.[27] For 2001 and prior tax years, distributions in the case of a sale of assets or stock of the business employing the employees are allowed only if the transferor corporation continues to maintain the plan after the disposition.[28] See §C:2.100 for discussion of CODAs and §C:14.20 for discussion of distributions, including lump-sum distributions.

[26] Code Sec. 401(k)(10)(B)(ii).

[27] Code Sec. 401(k)(10)(B)(i).

[28] Code Sec. 401(k)(10)(C), repealed for tax years after 2001 by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

COMMENT:

Congress in the Economic Growth and Tax Relief Reconciliation Act of 2001 eliminated the "same desk" rule for years after 2001. See §C:2.140 for discussion of this rule. The "same desk" rule is based on the Code provision allowing an employee who experiences a "separation from service" to receive distributions. Under the rule employees who continue on the same job for a different employer following a liquidation, merger, or consolidation, are not deemed separated from service. The result is that after mergers or acquisitions, employers are often forced to retain terminated employees in their plans. For years after 2001, however, all that is required is a "severance from employment," which would trigger distribution rights in the event the employer changes hands.[29] For distributions before 2002, there are ways

around the "same desk" rule if a corporate employer sells substantially all of the assets of a trade or business or sells a subsidary, but these routes can be taken only if the seller continues to maintain the plan after the disposition of the assets or stock. These exceptions have been repealed for distributions after 2001, since they are no longer needed in light of the repeal of the "same desk" rule.[30] The provisions of the 2001 Act are scheduled to sunset after December 31, 2010, unless Congress extends them.[31]

[29] Code Sec. 401(k)(2)(B)(i)(I), as amended by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

[30] Code Sec. 401(k)(10)(C), repealed for tax years after 2001 by the Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §646 (June 7, 2001).

[31] The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §901 (June 7, 2001).

To retain its status, the provisions of a qualified plan must provide that amounts held by a trust that are attributable to employer contributions made under an employee's election, that is, in a qualified CODA, are not distributable merely by reason of the employee having completed a stated period of participation or because a fixed number of years has elapsed.[32] Although the employer cannot restrict the participant's access if a CODA provides for deductible voluntary employee contributions, there is an additional 10-percent penalty tax on any withdrawals made before the participant attains the specified age of 59 1/2unless the distribution is rolled over into an IRA or another plan.[33] See §C:14.240 and §C:14.200 for discussion of early withdrawals and rollovers and §C:22.20 for discussion of IRAs.

[32] Code Sec. 401(k)(2)(B)(ii).

[33] Code Sec. 72(m)(5)(B).

In the case of a plan merger, the merged plan resulting from the transfer of assets or liabilities consists of the transferred assets and liabilities and the assets and liabilities of the transferee plan. The assets and liabilities are combined in a single plan, but do not lose the character they had before the transfer. In particular, pension plan assets remain pension plans assets, subject to limitations on distribution, and profit-sharing plan assets remain profit-sharing plan assets. Thus, for example, when a money purchase pension plan transfers assets and liabilities to a profit-sharing plan, the transferred assets remain pension plan assets. Therefore, the merged plan resulting from the transfer is disqualified if the merged plan permits distributions after a set period of years, as profit-sharing plans are permitted to do.[34] The same rule applies if there is a merger of the two types of plans, or if the transferee plan is a stock bonus plan.[35] See §C:15.40 for discussion of plan mergers.

[34] Rev. Rul. 94-76 , 1994-2 CB 46.

[35] Rev. Rul. 94-76 , 1994-2 CB 46.

PLANNING NOTE:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: The IRS has provided model language protecting profit-sharing and stock bonus plans from disqualification as a result of transfer from or merger with a money purchase plan. [36]

[36] Rev. Proc. 96-55, 1996-2 CB 387.

However, this rule does not apply if assets are transferred in a direct rollover from one plan to another rather than in a transfer of assets and liabilities, because assets transferred in a direct rollover are considered distributed and so are no longer treated as qualified plan benefits.[37] See §C:14.220 for discussion of direct rollovers

[37] Rev. Proc. 96-55 , 1996-2 CB 387.

A transferee plan that provides for distributions after a period of service can be amended to eliminate a distribution provision of this type in effect on or before December 12, 1994, solely with respect to benefits attributable to the pension plan without violating the restriction on reducing accrued benefits, provided that the plan amendment is adopted by June 30, 1997. See §C:6.180 for discussion of the restriction on reductions of accrued benefits. A plan is not considered disqualified if it contains this type of provision before December 12, 1994, as long as it is amended by June 30, 1997.[38]
individually designed plans entitled to extended reliance can be amended no later than the last day of the first plan year following the year in which the extended reliance period applicable to the plan ends, as long as the amendments are made effective no later than the first day of the plan year and no earlier than the first day of the plan year in which the amendments are adopted, and no transfer of assets or liabilities to the plan from a money purchase plan occurred or occurs after the date of the most recent determination letter and before the date the amendments are adopted.[39] Sponsors of these types of plans may use a model amendment provided by the IRS for this purpose.[40] See §C:17.106 for discussion of extended reliance and procedures for adopting plan amendments.

[38] *Id*; Rev. Proc. 96-55, §4, 1996-2 CB 387.

[39] *Id.*

[40] *Id*; Rev. Proc. 96-55 , §3, 1996-2 CB 387.

NEW DEVELOPMENTS

Management company's discharge of employees in connection with the sale of a managed property to new owners resulted in separation from service.

A hotel management company's discharge of its employees in connection with the sale of a hotel to new owners who put in place their own management resulted in the employees' separation from service from the company, notwithstanding the fact that substantially all of the employees were subsequently rehired by the new owner to perform substantially the same jobs at the same location. Consequently, the employees were allowed to receive distributions from the corporation's qualified plan under Code Sec. 401(k)(2)(B)(i)(I). The same desk rule prevents such distributions when the employee continues to perform the same job for a new employer as a result of the liquidation, merger or consolidation of the former employer (Rev. Rul. 79-336) or as a result of the termination of the former employer, if a successor employer is formed to continue the business (Rev. Rul. 80-129). In this case the same desk rule did not apply; there was no change in the organization of the management company, and the new owner was not a successor employer, within the meaning of Rev. Rul. 80-129. The IRS revoked IRS Letter Ruling 200009047, September 17, 1997, which came to a contrary conclusion.

IRS Letter Ruling 200030031, May 1, 2000.

Employees who received Code Sec. 401(k) distributions separated from service upon employer's sale of

assets to unrelated entity.

The IRS has held in a revenue ruling that distributions of amounts deferred by employees under a Code Sec. 401(k) cash or deferred arrangement (CODA) that occurred after their employer sold less than substantially all of its assets to an unrelated entity was made after the employees' separation from service. The employees, who were terminated by the seller and hired by the buyer, separated from the seller's service within the meaning of Code Sec. 401(k)(2))(B)(i)(I) on the date when the assets were transferred. The CODA did not fail to meet the requirements of Code Sec. 401(k)(2)(B) merely because the employees were permitted to receive distributions of their account balances, including amounts attributable to elective contributions. This holding is the same regardless of whether the seller or buyer is a corporation, or whether the buyer hires the employees pursuant to a contractual obligation.

With respect to sales of less than substantially all the assets of a trade or business occurring prior to September 1, 2000, the IRS will not treat a plan as failing to follow its provisions merely because the employer does not treat the termination of employment from the seller and hiring by the buyer as a separation from service and, thus, does not permit distributions from the plan to the terminated employees hired by the buyer.

Rev. Rul. 2000-27, 2000-21 I.R.B. 1016.

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CCH-EXP, CCH Federal Tax Service §C:4.162, Hardship Distributions

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Hardship Distributions --

The provisions of a qualified profit-sharing or stock bonus plan may allow the acceleration of the deferred distribution period and permit early withdrawals on a showing of hardship if:

The term hardship is defined;

The rules are uniformly and consistently applied; and

The amount distributed does not exceed the employee's vested interest.[41]

[41] Rev. Rul. 71-224, 1971-1 CB 124.

However, defined benefit pension and money purchase pension plans generally may not provide for hardship withdrawals without losing their qualified status.[42] If these plans provide for voluntary contributions to the plan, the withdrawal of the contributions may be restricted to hardship situations without necessarily causing the plan to be disqualified.[43]

[42] Rev. Rul. 56-393, 1956-2 CB 282.

[43] See Rev. Rul. 60-323 , 1960-2 CB 148.

The provisions of a cash or deferred arrangement (CODA) may allow hardship withdrawals without being disqualified. However, hardship withdrawals from a qualified CODA are limited to the amount of an employee's elective deferrals.[44] Only the elective deferral itself, rather than the interest it has earned, is available for hardship distribution.[45] See §C:2.141 .

[44] Code Sec. 401(k)(2)(B)(i)(IV).

[45] HR Rep. No. 841, 99th Cong., 2d Sess. II-389 (1986).

The regulations define a hardship distribution as one that is necessary because of the employee's immediate and heavy financial needs, which is necessary to satisfy the financial need. [46] A financial need may be immediate and heavy even if it was reasonably foreseeable or voluntarily incurred. [47] Certain distributions are deemed to be on account of an immediate and heavy financial need.

[46] Reg. § 1.401(k)-1(d)(2).

[47] Reg. § 1.401(k)-1(d)(2)(iv)(A).

- Expenses for medical care described in Code Sec. 213(d). See §A:14.41 .

  - Costs directly related to the purchase of a principal residence (excluding mortgage payments).

  - Payment of tuition, related educational fees, and room and board for the employee and his or her dependents.

  - Payments necessary to prevent eviction or foreclosure of an employee's principal residence. [48]

  [48] Reg. § 1.401(k)-1(d)(2)(iv)(A).

The amount of distribution may include amounts necessary to pay applicable taxes and penalties. [49]

[49] Reg. § 1.401(k)-1(d)(2)(iv)(B)(1).

EXAMPLE:

> A retirement plan participant needs $5,000 to stop foreclosure of home. It is anticipated that the participant will incur a 10-percent penalty tax for early distribution (see §C:20.146) and that the participant will be in a 28 percent marginal federal income tax bracket and 7 percent marginal state income tax bracket. The participant would be entitled to a hardship withdrawal of $7,250 calculated as follows:
>
> ```
> $5,000 + [$5,000 × (28% federal rate + 7% state rate + 10% penalty)] =
> $7,250
> ```
>
> This assumes that the participant has at least $7,250 of elective deferrals in his or her retirement plan account.

A distribution is necessary to satisfy an immediate and heavy financial need if (i) the employee has obtained all permissible distributions, other than hardship distributions, and all nontaxable loans, (ii) the employee elective deferral limitation in the Code (currently $10,000) less the employee's elective contributions for the year of the hardship distribution, and (iii) the employee is prohibited under any plan of the employer from making elective contributions for a prescribed period after the hardship withdrawal. [50] For tax years prior to 2002, an employee must wait at least 12 months after the hardship distribution before making elective and employee contributions.[51] For tax years beginning after 2001, the prohibition period is reduced to six months.[52] However, this shortened prohibition period, like the rest of the 2001 Act, is scheduled to sunset after December 31, 2010, and the Internal Revenue Code would thereafter be applied as if the change had not been made.[53]

[50] Reg. § 1.401(k)-1(d)(2)(iv)(B).

[51] Reg. § 1.401(k)-1(d)(2)(iv)(B)(4).

52 The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §636(a) (June 7, 2001)

53 The Economic Growth and Tax Relief Reconciliation Act of 2001, P.L. 107-16, Act §901 (June 7, 2001).

EXAMPLE:

If the retirement plan participant in the immediately preceding example had made a $9,000 elective deferral in the year of the hardship withdrawal (such withdrawal occurring on November 30, 1999), and the elective deferral limitation in the following taxable year were $10,000, the participant could elect to defer $1,000 in the following tax year (2000); however; such elective deferral would have to be made more than 12 months after the hardship withdrawal (or after November 30, 2000).

PLANNING NOTE:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: An employer may rely upon the employee's written representation (unless he or she has knowledge otherwise) that the need cannot otherwise be relieved through reimbursement or compensation by insurance, liquidation of other assets, cessation of elective contributions, distributions (other than for hardship) from other plans, or loans from other retirement plans or commercial lenders which are available upon commercially reasonable terms. [54]

54 Reg. § 1.401(k)-1(d)(2)(iii)(B).

The regulations also indicate that the amount distributed must not be more than is needed to solve the immediate problem and must not be reasonably available from other resources of the employee including the assets of the employee's spouse and minor children. These determinations must be made in accordance with uniform and nondiscriminatory standards set out in the plan.[55]

55 Reg. § 1.401(k)-1(d)(2).

Most hardship distributions are subject to the 10-percent penalty tax on early distributions,[56] although an exception exists for distribution amounts not exceeding the allowable deduction for medical expenses.[57] In addition, distributions from an IRA, a simplified employee pension (SEP), or a savings incentive match plan for employees (SIMPLE) are exempt from the 10-percent additional tax if they are used to pay for medical insurance, without regard to the 7.5-percent floor on deductible medical expenses (see §A:14.140), if the individual has received unemployment compensation under federal or state law for at least 12 consecutive weeks and the withdrawal is made in the year the unemployment compensation is received or the following year.[58] If a self-employed individual is not eligible for unemployment compensation under applicable law, then, to the extent provided in regulations, the self-employed individual is treated as having received unemployment compensation for at least 12 weeks if he would have received unemployment compensation but for the fact that he was self-employed.[59] This exception from imposition of the 10-percent additional tax ceases to apply once the individual has been reemployed for at least 60 days.[60] The exception from the 10-percent additional tax in the case of medical insurance for unemployed distributees is not available in years before 1997.[61] See §C:21.20 for discussion of SEPs and SIMPLEs, §C:22.20 for discussion of IRAs and §C:14.240 for discussion of the 10-percent penalty tax.

56 Code Sec. 72(t).

57 Code Sec. 72(t)(2)(B); see Code Sec. 213.

[58] Code Sec. 72(t)(2)(D)(i).

[59] Code Sec. 72(t)(2)(D)(iii).

[60] Code Sec. 72(t)(2)(D)(ii).

[61] P.L. 104-191 , 104th Cong., 2d Sess., §361(d) (Aug 21, 1996).

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CCH-EXP, CCH Federal Tax Service §C:4.180, Incidental Benefit Rules

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Incidental Benefit Rules--

Employer's provision of nonretirement benefits, such as life, accident or health insurance, to employees must be only incidental to qualified plan's primary purpose of distributing accumulated funds to employee as retirement benefits or deferred compensation. Provision of death benefits payable to employee's beneficiary is subject to same limitation.

For profit-sharing and stock bonus plans the incidental benefit rule requires that the employer's provision of employee nonretirement benefits, such as life, accident or health insurance, as well as the supplying of any death benefits payable to employee beneficiaries, must be only incidental to the plan's primary purpose of deferring compensation.[1] See §C:14.93 . Benefits are prohibited which are not customarily included in pension plans (the primary purpose of which is to provide retirement benefits) such as may be the case with layoff benefits or benefits for sickness, accident, or hospitalization (unless provided to retired employees). [2]

[1] Reg. § 1.401-1(b)(1)(iii); Proposed Reg. § 1.401(a)(9)-2, Q&A 1.

[2] Reg. § 1.401-1(b)(1)(ii) .

The incidental benefit rule does not apply to insurance benefits that are purchased with voluntary employee contributions. Thus, it is unnecessary to ascertain whether the provision of these insurance benefits is incidental to the plan's main purpose.[3] However, the source of funds used to purchase insurance must be specified; otherwise it is presumed purchased with employer contributions.[4] See §C:4.184.

[3] See Rev. Rul. 70-369 , 1970-2 CB 84; Rev. Rul. 69-408, 1969-2 CB 58.

[4] Rev. Rul. 68-390, 1968-2 CB 175.

Accordingly, under proposed regulations, a plan loses its qualified status for violation of the incidental benefit rule if it meets either of the following conditions:

The plan does not contain provisions reflecting the requirements imposed by the minimum distribution rules; or

Distributions under the plan in a calendar year do not satisfy the minimum distribution requirements.[5]

[5] Proposed Reg. § 1.401(a)(9)-2, Q&A 1A; see Code Sec. 401(a)(9) ; Proposed Reg. § 1.401(a)(9)-1, Q&A A-3.

The minimum distribution rules[6] are discussed in §C:14.80 .

[6] See Code Sec. 401(a)(9).

Before adoption of the incidental benefit rule, plan participants often selected a form of benefit that would postpone distribution of benefits until after their death. The beneficial consequences to the employee and his family in postponing the receipt of benefits were accentuated by an estate tax exclusion and favorable income tax treatment afforded the surviving spouse. The IRS, which has always taken the position that benefits must be payable primarily for the benefit of the participant rather than for his beneficiaries, countered by ruling that benefits provided to beneficiaries must be only incidental.[7]

[7] See Rev. Rul. 72-240, 1972-1 CB 108; Rev. Rul. 56-656 , 1956-2 CB 280.

A plan settlement option satisfies the incidental benefit rule if it contains provisions requiring that the present value of the payments to be made to the participant is more than 50 percent of the present value of the total [8]

[8] Rev. Rul. 74-325, 1974-2 CB 127; Rev. Rul. 72-241 , 1972-1 CB 108.

COMMENT:

CCH Tax Editors note that: Since the adoption of the required distribution amendments of 1984,[9] however, there is little real substance left to the incidental benefit rule as it pertains to whether payments must be made to the participant and/or his designated beneficiary. This is so because the Code now generally requires that all benefits be paid over the actuarial life of the participant, or the joint actuarial life of the participant and his spouse, commencing in the tax year in which the required beginning date of distribution falls.[10] The required beginning date in years beginning after 1996 is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2or the calendar year in which the employee retires.[11] In the case of IRAs or plans with participants who are 5 percent owners, such plans or IRAs must commence distributions by the April 1st following the calendar year in which the participant turned 70 1/2. [12] The 5 percent rule does not apply to stock of the employer in an ESOP. [13] In years beginning before 1997, the required beginning date for plans other than governmental plans or church plans is April 1 of the calendar year following the calendar year in which the employee attains age 70 1/2.[14] In the case of governmental plans or church plans in years beginning before 1997, the post-1996 rule applies. Thus, for such plans the required beginning date for these plans is April 1 of the calendar year following the later of the calendar year in which the employee attains age 70 1/2or the calendar year in which the employee retires.[15] The continuing vitality of the incidental benefit rule has shifted from issues revolving around benefit selection by the participant to those concerning financing ancillary benefits such as life insurance, which may be used in any type of plan, or health and accident insurance, a permissible feature of a profit-sharing plan. See §C:4.181
§C:4.182 for discussion of life insurance in defined contribution plans, §C:4.183 for discussion of life insurance in money purchase plans and §C:4.184 for discussion of life insurance and §C:4.186 for discussion of health and accident insurance.

[9] Code Sec. 401(a)(9).

[10] *Id.*

[11] Code Sec. 401(a)(9)(C)(i).

[12] Code Sec. 401(a)(9)(C)(ii).

[13] *Id.*

[14] Code Sec. 401(a)(9)(C), prior to amendment by P.L. 104-188, 104th Cong., 2d Sess., §1404(a) (Aug 20, 1996).

[15] *Id.*

A plan may provide for the payment of post-retirement death benefits without risking disqualification under the incidental benefit rule. See §C:4.185 .

See §C:4.187 for discussion of what survivorship provisions are deemed not incidental.

NEW DEVELOPMENTS

IRS releases new proposed regulations relating to required minimum distributions.

The IRS has proposed new regulations that will replace its 1987 proposed regulations relating to required minimum distributions. These new proposed regulations are applicable for determining required minimum distributions for calendar years beginning on or after January 1, 2002. For purposes of determining required distributions for calendar year 2001, taxpayers may rely on either the 1987 proposed regulations or these new 2001 proposed regulations.

Under the 2001 proposed regulations, satisfaction of the minimum distribution requirements satisfies the minimum distribution incidental benefit (MDIB) requirements, and therefore the separate MDIB requirements found in Proposed Reg. § 1.401(a)(9)-2
material in the 2001 proposed regulations.

Proposed Reg. § 1.401(a)(9)-1 through Proposed Reg. § 1.401(a)(9)-8, issued with Notice of Proposed

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CCH-EXP, CCH Federal Tax Service §C:4.181, Life Insurance in Defined Benefit Plans

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Life Insurance in Defined Benefit Plans --

A qualified pension plan may provide for disability payments and preretirement death benefits (through insurance or otherwise) as long as these benefits are incidental.[16] See §C:4.180. However, the primary purpose of a qualified pension plan is to provide systematically for the livelihood of employees or the employees' beneficiaries after the retirement of the employees by making benefit payments that are definitely determinable and calculated without regard to profits.[17] Ordinary life insurance does not meet this requirement, and a plan must do more than rely on it alone.[18]

[16] Reg. § 1.401-1(b)(1) .

[17] Reg. § 1.401-1(a)(2)(i), (b)(1)(i).

[18] See Reg. § 1.401-1(a)(2)(i), (b)(1)(i).

EXAMPLE:

> Amalgamated Corporation establishes a plan that provides its employees with benefits realized through the purchase of ordinary life insurance contracts. The terms of the plan require the life insurance contracts to be converted into life annuities at the normal retirement date. The accumulated reserve from regular premium payments can purchase only a relatively small retirement annuity in comparison to one that can be purchased under a retirement income contract with the same face amount. Amalgamated's plan does not constitute a qualified plan because the primary purpose of an ordinary life insurance contract is to provide life insurance protection rather than to pay benefits to employees over a period of years after their retirement.[19]
>
> [19] Rev. Rul. 81-162, 1981-1 CB 169.

In general, the life insurance benefit in a defined benefit plan funded with insurance contracts is deemed to be incidental if any of the following three conditions is met:

Less than 50 percent of the employer contribution credited to each participant's account is used to purchase ordinary insurance policies on the participant's life, even if the total death benefit consists of both the face amount of the policies and the amount credited to the participant's account in the auxiliary fund;

The preretirement death benefit is no greater than 100 times the anticipated monthly normal retirement benefit (for example, $1,000 of life insurance for each $10 of monthly annuity); or

The death benefit does not exceed the reserve under the ordinary life policies plus the participant's account in the auxiliary fund.[20]

[20] Rev. Rul. 74-307, 1974-2 CB 126, clarifying and modifyig Rev. Rul. 73-501, 1973-2 CB 127; Rev. Rul. 68-453 , 1968-2 CB 163.

The plan may satisfy alternate tests in different years.

Of the three tests stated above, the first and third choices are limited because they require an allocated funding method. Allocated funding methods are found only in a limited number of plans, such as target benefit plans. Thus, the 100 times the monthly benefit rule is most likely to apply to the typical defined benefit plan with unallocated funds.

COMMENT:

CCH Tax Editors note that: Difficulties occur when new legislation reduces the permissible benefit afforded plan participants, the measure used to determine the incidental nature of preretirement life insurance. This type of reduction has happened twice in recent years, first with the passage of the Tax Reform Act of 1984 (TRA 1984)[21] and later with the enactment of the Tax Reform Act of 1986 (TRA 1986).[22] The IRS provided for a form of grandfathering in the first instance under which, provided certain conditions were met, defined benefit or defined contribution plans providing a preretirement death benefit were not required to reduce that benefit to satisfy the incidental death benefit rules.[23] In the second instance, however, the old benefit was not grandfathered, and death benefits that exceed the incidental death benefit limits because of the amendments cannot be provided.[24]

[21] P.L. 98-369, 98th Cong., 2d Sess. (July 18, 1984).

[22] P.L. 99-514, 99th Cong., 2d Sess. (Oct 22, 1986).

[23] Notice 83-10, 1983-1 CB 536, 543; see Reg. § 1.401-1(b)(1).

[24] Notice 87-21, 1987-1 CB 458.

The permissible life insurance benefit discussed in this section is a benefit realized pursuant to policies taken out on the life of the participant only. A participant cannot invest or gamble with his benefit by investing part of the account in life insurance contracts on the life of anyone in whom the participant has an insurable interest. To do so could possibly provide a prohibited incidental benefit in addition to the participant's definitely determinable benefit.[25]

[25] Rev. Rul. 69-523, 1969-2 CB 90.

COMMENT:

Paul D. Callister of Callister and Callister, LC, Glendale, CA, notes that: A notable exception to the incidental benefit rule is taken for 412(i) plans, which under the Code are defined benefit plans wholly funded with individual insurance contracts and which are exempt from the minimum funding accrual requirements of the Code. [26]

[26] Code Sec. 412(h)(2) and (i).

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CCH-EXP, CCH Federal Tax Service §C:4.182, Life Insurance in Defined Contribution Plans

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Life Insurance in Defined Contribution Plans --

A profit-sharing plan, although primarily a plan of deferred compensation, may use amounts allocated to the account of a participant to provide incidental life, accident or health insurance.[27] Profit-sharing plans providing preretirement life insurance benefits must satisfy two tests to meet the incidental benefit rule.[28]

[27] Reg. § §1.401-1(b)(1)(ii) , Reg. 1.403(a)-1(d).

[28] Rev. Rul. 60-83, 1960-1 CB 157.

Under the first test, preretirement life insurance may be purchased with current contributions to a profit-sharing plan when the amount invested is incidental to the plan's primary purpose of permitting the employees or their

[29] Although trust funds used to purchase current

[30]

a profit-sharing plan may properly be made after the funds have been held or accumulated for a fixed number of years. For this purpose, a fixed number of years is a period of at least two years.[31] Thus, the purchase of life insurance with trust funds accumulated for two or more years constitutes a distribution that does not disqualify a profit-sharing plan.[32] See §C:14.182.

[29] *Id*; see Reg. § 1.401-1(b)(1)(ii).

[30] Reg. § 1.402(a)-1(a)(3).

[31] Rev. Rul. 54-231, 1954-1 CB 150.

[32] Rev. Rul. 60-83, 1960-1 CB 157.

Under the second test, a limited percentage of contributions may be applied either to insurance or to benefits without violating the incidental benefit rule. The effect of this requirement is similar to that applicable to defined benefit plans. See §C:4.181. Thus, a profit-sharing plan may meet either the 100 times the monthly benefit test,[33] or it may use ordinary life insurance and meet the 50-percent limitation test.[34]

[33] See Rev. Rul. 60-83, 1960-1 CB 157.

[34] See Rev. Rul. 73-501 , 1973-2 CB 127; Rev. Rul. 69-421, Part 2(n)(2), 1969-2 CB 59; Rev. Rul. 54-51, 1954-1 CB 147, amplified by Rev. Rul. 60-85, 1960-1 CB 181; Rev. Rul. 57-213, 1957-1 CB 157.

In the profit-sharing setting, the following requirements must be met to satisfy the 50-percent limitation test:

(1)

The aggregate amount of premiums to be paid for insurance on a participant's life for a whole life policy is at all times less than 50 percent of the aggregate of the contributions and forfeitures, without regard to trust earnings and capital gains and losses, that have been allocated to the participant. The 50 percent

limitation is reduced to 25 percent if term insurance is purchased instead of whole life

(2)

The plan requires the trustee, at or before the participant's retirement, to do one of the following:

(a)

convert the policy into cash or provide the participant with retirement income without life insurance protection, or

(b)

distribute the policy to the employee.[35]

[35] *Id.*

Thus, profit-sharing plans may use only seasoned contributions (that is, those held in the plan for more than two years), in which case no other limitations are imposed on the amount of insurance provided,[36] or the plan may use current contributions and meet either the 50-percent limitation test for whole life policies (and 25 percent for term policies) [37] or the 100 times monthly benefit test.[38] See §C:4.181 .

[36] Rev. Rul. 60-83, 1960-1 CB 157.

[37] See Rev. Rul. 73-501, 1973-2 CB 127; Rev. Rul. 69-421 , Part 2(n)(2), 1969-2 CB 59; Rev. Rul. 54-51, 1954-1 CB 147, amplified by Rev. Rul. 60-85, 1960-1 CB 181; Rev. Rul. 57-213, 1957-1 CB 157.

[38] See Rev. Rul. 60-83, 1960-1 CB 157.

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CCH-EXP, CCH Federal Tax Service §C:4.183, Life Insurance in Money Purchase Plans

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Life Insurance in Money Purchase Plans --

A money purchase plan may provide incidental preretirement life insurance benefits by meeting the tests imposed on either profit-sharing plans (see §C:4.182) or defined benefit pension plans (see §C:4.181).[39]

[39] Rev. Rul. 74-307, 1974-2 CB 126; Rev. Rul. 66-143, 1966-1 CB 79, *clarified by* Rev. Rul. 69-421, Part 2(n)(1), 1969-2 CB 59; Rev. Rul. 68-31, 1968-1 CB 151.

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CCH-EXP, CCH Federal Tax Service §C:4.184, Voluntary Employee Contributions Used to Purchase Life Insurance

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Voluntary Employee Contributions Used to Purchase Life Insurance --

A participant in either a profit-sharing or pension plan may, if the plan so provides, direct that his voluntary contributions be used to purchase additional life insurance without being constrained by the incidental benefit rule. However, a participant may not direct that the earnings on his voluntary contributions be used for this purpose.[40]

[40] Rev. Rul. 69-408, 1969-2 CB 58.

COMMENT:

> **CCH Tax Editors** note that: The terms of the plan must identify the source of the premium payments. In the absence of this designation, the presumption is that the premium payments are paid first from employer contributions. Premium payments deemed made by an employer are subject to the incidental benefit rule and are includable in the employee's gross income for income tax purposes.[41]
>
> [41] Rev. Rul. 68-390, 1968-2 CB 175.

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Post-retirement Death Benefits --

A plan may provide for the payment of post-retirement death benefits without risking disqualification under the incidental benefit rule.[42] If a married participant dies after attaining normal retirement age, a benefit must be paid to his surviving spouse and, in some instances, to his designated beneficiary. Payment is usually made to the surviving spouse if the participant was married, because, unless waived, the qualified joint and survivor annuity (QJSA) is the required form of benefit for a married vested participant in a defined benefit plan or money purchase plan.[43] See §C:14.100.

[42] Reg. § 1.401-1(b)(1)(i).

[43] Code Sec. 401(a)(11)(A)(i), (B)(i) , (ii)

Participants who were unmarried or who elect another form of benefit extending beyond the participant's life, such as an annuity for a term certain, can designate a contingent beneficiary other than the participant's spouse.[44] The election must be consented to by the participant's spouse in accordance with stringent consent procedures requiring written disclosure and either witnesses or notarized signatures.[45]

[44] Code Sec. 401(a)(11).

[45] Code Sec. 417(a)(2).

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CCH-EXP, CCH Federal Tax Service §C:4.186, Health and Accident Plans for Retired Employees

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Health and Accident Plans for Retired Employees --

A pension or annuity plan may provide sickness, accident, hospitalization and medical benefits for retired employees, their spouses and their dependents if all of the following conditions are satisfied:[46]

[46] Code Sec. 401(h); Reg. § 1.401-14(b), (c).

The benefits are paid out of a separate account;

The employer's contributions to the account are reasonable and ascertainable;

The benefits provided are subordinate to the retirement benefits provided under the plan;

The terms of the plan require that any amount remaining in the separate account be returned to the employer upon satisfaction of all liabilities under the plan to provide the benefits; and

A separate account is established and maintained to provide the benefits to key employees, their spouses and their dependents.

Health and accident benefits are subordinate to the retirement benefits provided if the contributions made to provide medical benefits, plus the contributions made to provide life insurance, do not exceed 25 percent of the total contributions to the plan after the plan establishes the account from which the health and accident benefits are provided.[47] See §C:3.48.

[47] Code Sec. 401(h).

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CCH-EXP, CCH Federal Tax Service §C:4.188, Survivorship Provisions That Are Not Incidental

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Survivorship Provisions That Are Not Incidental --

The IRS has provided only sparse guidance as to what survivorship provisions it deems not incidental. However, in one ruling,[52] the IRS held that a plan did not violate the incidental benefit rule because the trustee was authorized to select a mode of settlement that would result in the participant's beneficiary receiving more than one half of the benefits derived from the funds accumulated on the employee's behalf. Under the facts presented, the plan provided that the trustee could use the funds in a participant's account to purchase an annuity contract at the normal retirement age of 65. The payment commencement date and the amount of the regular monthly annuity payments were to be adjusted to best meet the participant's needs, but any funds remaining at the participant's death were to be paid to the designated beneficiary.[53]

[52] Rev. Rul. 72-241, 1972-1 CB 108.

[53] *Id.*

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Plan Years--

Plan's 12-month accounting period is called plan year. In usual single-employer setting, plan year coincides with employer's tax year and has little significance. However, plan year has additional significance when it does not coincide with employer's tax year. IRS generally must approve changes in plan and trust years. Approval is automatic if certain requirements are met.

The annual accounting period adopted by the plan for record-keeping purposes is called the plan year. The plan year may or may not coincide with the employer's tax year. See §C:4.201 . Special rules govern the calculation of the deductible limit for the employer's tax year when it does not coincide with the plan year. See §C:4.202 . Changes in plan and trust years are given automatic approval in some circumstances. See §C:4.203.

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CCH-EXP, CCH Federal Tax Service §C:4.201, Contrasted With Employer's Tax Year

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Contrasted With Employer's Tax Year --

The annual accounting period adopted by the plan for record-keeping purposes is called the plan year. The plan year, which is defined as the plan, calendar, policy or fiscal year on which the plan's records are kept,[1] may or may not coincide with the employer's tax year. The plan year may be used to measure the service required for accrual of benefits and for vesting computations. In some instances, different 12-month periods, such as periods commencing with each employee's date of hire, is required or may be elected for this purpose. However, the increased administrative costs incurred by selecting this alternative 12-month period usually more than offset the marginal ability to defer plan entry and minimize benefit accrual that it presents. See §C:7.100.

[1] ERISA §3(39); 29 U.S.C. §1002(39); Rev. Proc. 87-27 , §3.01, 1987-1 CB 769.

A trust year is any consecutive 12-month period that corresponds to the trust's tax year.[2]

[2] Rev. Proc. 87-27, §3.02, 1987-1 CB 769.

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CCH-EXP, CCH Federal Tax Service §C:4.202, Effect of Plan Year That Is Different From Employer's Tax Year

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Effect of Plan Year That Is Different From Employer's Tax Year --

Although the deductible limit for a defined benefit plan applies for an employer's tax year, it is determined on the basis of the plan year.[3] Thus, the deductible limit for the tax year is the deductible limit for the plan year that coincides with the tax year in cases in which the employer's tax year and the plan year are the same. However, if the two do not coincide, the deductible limit for the employer's tax year is calculated as one of the following (see §C:12.121):

[3] Reg. § 1.404(a)-14(c); Rev. Proc. 87-27, §2.04, 1987-1 CB 769.

the deductible limit determined for the plan year that begins in the tax year;

the deductible limit determined for the plan year that ends in the tax year; or

a weighted average of these two alternatives (for example, an average based on the number of months of each plan year that fall within the tax year).[4]

[4] Reg. § 1.404(a)-14(c)(1) ; Rev. Proc. 87-27, §2.04, 1987-1 CB 769.

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CCH-EXP, CCH Federal Tax Service §C:4.203, Changes in Plan and Trust Years

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Changes in Plan and Trust Years --

The IRS distinguishes between the plan year and the trust year (see §C:4.201), and a change for each must be requested on Form 5308, Request for Change in Plan/Trust Year. Profit-sharing plans are excused from obtaining approval for a change in plan year, but they require approval for a corresponding change of the tax year of the trust.[5]

[5] Rev. Proc. 87-27, 1987-1 CB 769; Form 5308, Request for Change in Plan/Trust Year, Instructions (July 1998).

Changes in plan and trust years are given automatic approval in some circumstances without requiring any correspondence with the IRS. Employers or plan administrators must apply for changes in plan or trust years that do not qualify for automatic approval by filing Form 5308, together with a statement identifying the requirement for automatic approval that has not been met and specifying the reason for not satisfying it.[6]

[6] Rev. Proc. 87-27, §4.02, 1987-1 CB 769.

The following conditions must be satisfied to obtain automatic approval from the IRS for changes in plan and trust years:

(1)

No plan year is longer than 12 months;

(2)

No change of plan year has been made for any of the four preceding plan years;

(3)

The change does not postpone the time when the plan would otherwise have been required to conform to the requirements imposed by any statute, regulation or published position of the IRS;

(4)

The trust, if any, retains its exempt status for the short period required to effect the change, as well as for the immediately preceding tax year;

(5)

All actions necessary to implement the change of plan year have been taken on or before the last day of the short period, including amendment of the plan, and if necessary, a resolution of the board of directors; and

(6)

The trust, if any, has no unrelated business taxable income[7] for the short period.[8]

[7] See Code Sec. 511.

[8] Rev. Proc. 87-27, §4.01, 1987-1 CB 769.

A plan or trust year satisfying these requirements may be changed without obtaining prior approval from the IRS.[9]

[9] Rev. Proc. 87-27, §4.01, 1987-1 CB 769; see Announcement 88-97, 1988-26 I.R.B. 47.

Special rules governing the deductible limit[10] also must be satisfied in the case of a change in the plan year of a defined benefit plan.[11] The deductible limit for a defined benefit plan is obtained by multiplying the sum of the deductible limits for the associated plan years by a fraction, the numerator of which equals the number of months in the employer's tax year and the denominator of which is the aggregate number of months in plan years associated with the tax year, under either of the following conditions:

[10] Code Sec. 404(a)(1).

[11] Rev. Proc. 87-27, §4.018, 1987-1 CB 769; see Reg. § 1.404(a)-14(c).

The change in plan year results in more than one plan year being associated with the employer's tax year; or

The sum of the number of months of each plan year associated with the employer's tax year is different from the number of months in the employer's tax year.[12]

[12] Rev. Proc. 87-27, §5, 1987-1 CB 769.

The deductible limit for a short plan year is calculated by ratably reducing the deductible limit for a 12-month plan year in proportion to the number of months in the short year.[13]

[13] Rev. Proc. 87-27, §5.02, 1987-1 CB 769.

EXAMPLE 1:

A calendar-year employer computed the deductible limit for a defined benefit plan on the basis of the plan year commencing October 1 within the calendar year. In 1998, however, the employer changed the plan year to a calendar-year basis. This resulted in a short plan year beginning on October 1, 1998, and ending on December 31, 1998. The plan uses an aggregate funding method, and the normal cost for the 12-month plan year commencing October 1, 1998, is $24,000. The deductible limit is not reduced by the full funding limit and is not increased by the amount necessary to satisfy the minimum funding standard.[14] See §C:11.20 for discussion of minimum funding requirements.

[14] See Code Sec. 404(a)(1)(A)(i) .

The plan year associated with the employer's 1998 calendar year, that is, the employer's tax year, is the plan year commencing October 1, 1998, and ending December 31, 1998. The deductible limit determined on the basis of this short plan year is $6,000 ($24,000 × 3/12). The deductible limit applicable to the employer's 1997 tax year is $24,000, which is the product of the deductible limit for the short plan year, $6,000, multiplied by the fraction 12/3. For 1999 and succeeding tax years, the deductible limit is the limit for the plan year coincident with the tax year determined in conformity with applicable regulations.[15]

[15] Rev. Proc. 87-27, §5.04, Ex (1), 1997-1 CB 769; see Reg. § 1.404(a)-14(d).

EXAMPLE 2:

Assume the same facts as those in Example 1, except that the taxpayer creates a short plan year beginning October 1, 1998, and ending on November 30, 1998, and subsequent plan years commence on December 1. In addition, assume that the normal cost for the 12-month plan year beginning on December 1, 1998, is $38,000.

For the 1998 calendar year of the employer (the employer's tax year), both the plan year commencing October 1, 1998, and ending November 30, 1999, and the plan year commencing December 1, 1998, and ending November 30, 1999, are associated with that tax year. The number of months of plan years associated with the tax year equals 14. The deductible limit determined on the basis of the short plan year commencing October 1, 1998, is $4,000 ($24,000 ×
commencing December 1, 1998, is $38,000. The deductible limit for the tax year (calendar year 1998) is $36,000, obtained by multiplying the sum of the deductible limits, $42,000 ($4,000 + $38,000), by 12/14. The deductible limit for 1999 and succeeding tax years is determined on the basis of the deductible limit for the 12-month plan year commencing on December 1 within the employer's tax year (calendar year) as computed under the applicable regulations. Thus, the deductible limit for the 1999 tax year is determined with reference to the deductible limit for the plan year beginning on December 1, 1999.[16]

[16] Rev. Proc. 87-27, §5.04, Ex (2), 1997-1 CB 769; Reg. § 1.404(a)-14(d) .

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