RECORD OF SOCIETY OF ACTUARIES
1986 VOL. 12 NO. 1

VIEW FROM THE INTERNAL REVENUE SERVICE (IRS)

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- Current issues relating to compliance with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA) and the Retirement Equity Act of 1984 (REA).

MR. LEROY B. PARKS, JR.: Our speaker for this session is Ira Cohen, Director of Employee Plans, Technical and Actuarial Division, of the Internal Revenue Service. Throughout the years, he has worked on a host of legislative and regulatory projects. He also teaches a course in deferred compensation at George Washington University.

MR. IRA COHEN: The first thing I want to talk about is IRS Notice 86-3. Notice 86-3 deals with plans that have not complied in a timely manner with the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA), the Deficit Reduction Act of 1984 (DEFRA) and the Retirement Equity Act of 1984 (REA).

The first thing one has to look at is the compliance date. For an employer with a calendar year plan, the compliance date for TEFRA is November 1, 1985, and for DEFRA and REA it is generally December 31, 1985. Now, how does Revenue Ruling 82-66 interrelate with Notice 86-3? Revenue Ruling 82-66 deals with plans that have a disqualifying plan provision within the meaning of 401(b) of the Code. It has been defined that TEFRA is such a disqualifying plan provision. So, Revenue Ruling 82-66 applies to TEFRA; it does not apply to DEFRA and REA. Notice 86-3 says that plans which have not met the compliance date will not be totally disqualified. Notice 86-3 provides relief from many of the sanctions that exist if a plan fails to qualify. Under this notice, non-key employees never have any inclusion in income. The trust is not taxed. Now as a result of ERDA, the normal constructive receipt rules for qualified plans have been changed so that, if an amount is made available, it is not taxed if it is not distributed (only true for qualified plans, for both key and non-key employees). Therefore, a key employee or a non-key employee would not have inclusion in income merely because amounts were made available. There is a certain favorable tax treatment given to lump sums, which are protected for non-key employees. Rollover treatment is protected for non-key employees, and a large portion of the tax deductible limit is protected also.

How does Notice 86-3 operate? It looks at the amount of time that the plan is late in complying. Starting from November 1, 1985, it looks at how many months have ended after the compliance date, but before a determination letter was requested. For the months of November and December of 1985, and January and February of 1986, there is a reduction of 5% on the deductible limit or the contribution, whichever is applicable. For March 1986 and the months thereafter, there is a reduction of 10% for each month. So, the later the submission is relative to the compliance date, the less the relief that is granted by Notice 86-3. In effect, there is no penalty at all if a submission is made by the end of the month containing the compliance date. For example, a filing for a determination letter that was due November 1, if submitted by November 30, would draw no penalty, because no months ended after the compliance date and before the amendment was submitted to the IRS.

Actually, when a plan is not qualified, the deduction is not totally disallowed; the amount would be deductible under another section of the code, Section 404(a)(5). Under section 404(a)(5), the amount that would be deductible would be the amount that is includable in the employees' income, and it is includable when it is not subject to substantial risk of forfeiture. So this amount would always be deductible. Notice 86-3 does not take away a deduction that would otherwise be permitted under the law.

A second item in Section 404(a)(5) is: there is never a deduction for contributions to a defined benefit plan. The reason for this is that Section 404(a)(5) has a provision which states that the deduction does not apply in the event that separate accounting is not maintained, and in a defined benefit plan, by its very nature, separate accounting is not maintained. Now that I have said that, how does Notice 86-3 deal with this? In most cases, the deductible limit after the 5% and 10% phase outs will probably exceed the Section 404(a)(5) limit -- the contribution that will be allowable. It will always do this in the defined benefit plan. In that case the deduction would be the phased-in amount and there would be no inclusion in income for the key employees. However, in the case in which the Section 404(a)(5) amount exceeds the phased-in amount, the excess amount will be includable in the income of the employees. However, the includable income would not be the total amounts that would apply under 404(a)(5) -- only the excess of the Section 404(a)(5) amounts, if any, over the amounts that would be deducted for qualified plans after the phase-in.

All that is known at this point is the total amount that would have to be includable in income of all the key employees. Therefore, some sort of ordering rule is needed in states which key employees have inclusion in income. The rule that was adopted looks at what would be includable income for all key employees as contributions to a non-qualified plan. Then the key employees are put in the order of ownership, and you allocate first to a higher owner (one with greater amount of ownership), then to a lower owner. If two people own the same amount (same ownership), then the rule would ratably allocate. Finally, people who own less than 5% who are key employees will all be treated as one pool and everything will be ratably allocated, if the amount even gets that far. The amount of inclusion will always be less than or equal to the amount that you would have as contributions to a non-qualified plan.

A corollary is that in a defined benefit plan there is never an inclusion in income of the key employees, because the situation I described could not happen.

If you want to utilize this relief, first of all you have to request the relief, and this request could be made any time before the determination letter is actually issued. When you request the determination letter, if you are late the IRS will issue a prospective letter. Once you request the relief, you have to indicate that you will file amended returns which may be necessary. After the determination letter is issued, you have to file the amended returns and send a copy to the key district director. Then you will be getting a second letter, a 7805(b) letter, which will grant the relief.

There are a number of questions that I have heard on this notice. The most frequent question is "What if I had amended the plan, executed the amendment, and then did not submit, but I had executed the amendment on time? Does the plan lose some of its deductions ?" Well, let's look at a few points. Under the law, there is no requirement that anyone ever request the determination letter. This program is purely voluntary. One requests the determination letter for two fundamental reasons, as follows:

1. You can get the opinion of the IRS as to whether or not the plan is qualified, and

2. A favorable determination letter is somewhat of an insurance policy. In the unlikely event that the IRS ever makes an error in the issuance of a determination letter, you would be able to rely, normally, on that favorable letter and therefore the qualification of the plan would not be affected. So it is a form of protection.

What happens if you had amended the plan on time and had not requested a determination letter? Then you don't have the insurance. You now request a determination letter, and if the plan that was submitted is correct, you do not need the relief provided by Notice 86-3. The plan is clearly qualified and there is no problem. Suppose there are substantive errors in the plan. Then the amendment that you made was one which did not have the insurance protection and Notice 86-3 will provide the relief, but that relief will be provided based on the date of submission, not the date of execution. You could submit a plan to the IRS for a determination letter in proposed form; you do not have to execute the amendment before you submit it to the IRS. The mere submission will stop the clock, not the execution.

We have given the field certain instructions. The two situations which are clear are: (1) what happens when the plan is perfect, and (2) what happens when the plan has a substantive error. There is also a gray area. Sometimes the IRS looks at a plan and determines that your language may be interpreted in a way that will satisfy the law. On the other hand, your language may be interpreted in a way that will not satisfy the law. The language is ambiguous. If you change the language to clarify it, there will be no ambiguity. In the case of changes that are merely clarifying in nature and non-substantive, the plan will not be treated as if it had failed to satisfy the requirements. If all evidence shows the intent was correct, and the language, although ambiguous, could be interpreted consistently with that intent, such clarifying amendments will not cause any loss of deductions.

Another thing people wonder about is what happens if there is a disagreement with the IRS. Can you exercise the remedies that exist under the law without subjecting yourself to any added risk of loss of deductions if you are wrong? For example, suppose you disagree with something in a regulation or in an interpretation of the regulation and want to apply for a declaratory judgment. May you do so? The answer is "yes." The purpose of Notice 86-3 is not to try to force any positions that we may take on the substantive law. Any of the procedural rights you had before, you still have. If you litigate a particular point, and you win, that will be the rule, and when a plan was executed or submitted would determine the deduction. If you lose, there will be no added loss of deduction for as long as you amend the plan to conform within 91 days after the declaratory judgment. The purpose of Notice 86-3 is not to hamstring any disagreements that may occur; the purpose is to obtain compliance as timely as possible.

The second area that I would like to talk about is the alternative benefits regulation. As background, the IRS issued Revenue Ruling 85-59, which dealt with discrimination, primarily for lump sum distributions. The IRS has seen a number of situations in plans. In the first situation, plans provided a lump sum distribution only upon consent of the employer alone; in practice, the employer consented to lump sum distributions only in the case of people with sufficient pay. In other words, the employer allowed lump sums for officers and other highly compensated employees, but not for the rank-and-file employees. Is this discriminatory? Some people have argued that a lump sum is merely an actuarial equivalent and the fact that it is paid in a different form cannot possibly be discriminatory. The IRS did not buy that argument. It seems to me that if you have two individuals, a highly compensated employee and a rank and file employee, each of whom goes to a doctor and is told he has two months to live, if the highly compensated employee is able to get a lump sum distribution and the rank-and-file employee gets a life annuity, there is a significant difference in the value of the benefit, whether or not the plan administrator took health into consideration.

A second type of situation did not involve discretion on the part of the plan administrator, but involved fairly objective criteria. For example, you can get a lump sum distribution only if your net worth exceeds a certain amount of money. If that is the case and, as one might expect, the net worth of the highly compensated employee normally exceeds the net worth of the rank-and-file employee, this too will be something discriminatory.

We indicated in Revenue Ruling 85-59 that the above two types of situations are discriminatory. In January, 1986, we issued a regulation which basically reaffirmed that position. However, it went further than that. The regulation issued in January looked at the whole area of consent. I am going to use the term "employer consent" to mean the consent of the employer, the plan administrator, the actuary, attorney, or any of the practitioners associated with maintenance of the plan. Now suppose there is no discrimination at all, and you have benefits that are available only upon consent of the employer. Is this a problem? We came to the conclusion that there are several problems with this.

The first problem is that we have taken the position in prior revenue rulings that "definitely determinable" means that the benefit must be available without the consent of the employer. Revenue Ruling 79-90 said the benefit could not vary with the discretion of the employer; "consent" seems to be a special case of discretion. Revenue Ruling 79-90 was dealing with the choice of actuarial assumptions for benefit equivalence. This case deals with whether the option could be provided at all, and we feel that this is a violation of the "definitely determinable" requirement.

The second problem occurs as a result of Section 301 of REA. Section 301 of REA modified Section 411(d)(6) of the Code, which contains the anti-cutback rules. Section 301 of REA says that you can't decrease an accrued benefit by a plan amendment. Now, is making plan benefits subject to the consent of the employer something that is inherently in violation of Section 411(d)(6) of the Code? We concluded it is. Section 411(d)(6) of the Code was designed to preclude an amendment which took away a benefit. Taken to its logical conclusion, could a plan establish all of its benefits as being subject to the consent of the employer, and anytime the employer wishes, could the employer simply withhold consent and nobody gets benefits from the plan? That obviously cannot be. You can't take subsidized benefits which were intended to be protected by Section 411(d)(6) of the Code and simply subject them to consent. This would give an employer the ability at some future time to simply eliminate them by changing the standards used for consent. This is true whether or not there is discrimination. You can have a plan covering only hourly-paid employees, no officers, shareholders or highly compensated employees. The Section 411(d)(6) issue would still be an important issue.

The third situation is in the area of qualified domestic relations orders (QDROs). Under a QDRO, under REA, the former spouse of a participant can receive any benefit form available to the participant. If the QDRO specifies a form of benefit, that QDRO is valid only if it specifies a form of benefit available under the plan. If there is employer consent to receive a form of benefit, you may have a situation in which the employer has to look at a family dispute and try to decide, "Do I, as an employer want to protect my plan participants or do I want to protect the former spouses of plan participants?" You can have situations where otherwise valid qualified domestic relations orders could be defeated by the exercise of consent.

What has to be done to comply with the January regulation? Clearly, Section 411(d)(6) of the Code would preclude the elimination of the option. The regulation would require making the option available without consent. The IRS found several problems with this solution. First, the IRS has for many years. despite the definitely determinable requirement, issued determination letters on plans that had consent requirements. The IRS has never had a published revenue ruling dealing with definitely determinable and consent, but it has published revenue rulings on discrimination. Revenue Ruling 85-59 was one such ruling, in which consent was mentioned in connection with discrimination but not in connection with definitely determinable. We felt employers had established the options with one set of rules in mind, and that it would be unfair if it now required the broadening of those options. Second, the IRS was also concerned about plans where broadening options such as lump sum options might cause serious cash flow problems with the plan. It may be that, with a relatively small group of people, the lump sums could be made available, but if everyone takes them, there may be a cash flow problem. If the option was subject to consent or was discriminatory, we gave a window-period of time during which the employer could eliminate the option with no problem.

Are we taking a position that would totally eliminate all subjectivity from the administration of qualified plans? The answer is no. There is no way you could have the types of benefits provided under qualified plans and not have some subjectivity. For example, plans can have disability benefits. Even after you define standards, there is clearly going to be some amount of subjectivity that is involved in administering the disability benefit. Plans have plant closing benefits, which also have some amount of subjectivity. When is a plant actually closed? There is private litigation dealing with these issues. We are not attempting to totally eliminate any subjectivity. I don't think it is possible to do it, given the nature of the types of provisions that are now found in qualified plans. What the January regulation is really trying to do is eliminate very broad consent-type provisions, or discretionary provisions.

Moving to another issue, I receive a lot of questions on TEFRA's $200,000 limit on top-heavy plans. What does the $200,000 do? The $200,000 is a discrimination test. It is not used for anything other than discrimination. The $200,000 limit would apply in any case in which you are testing for discrimination. Suppose I had a defined-contribution plan that was top heavy, and I had a $30,000 contribution made for someone who was earning $300,000, and a $2,000 contribution made for someone earning $20,000. The contribution in each case is 10% of the total earnings. In order to determine whether or not it is discriminatory, you have to consider only the first $200,000 of earnings. The $30,000 contribution is 15% of the first $200,000, not 10%, so there may be discrimination. The $200,000 limit would apply for purposes of the special discrimination test in Section 401(k). It would also apply when testing for comparability under Revenue Ruling 81-202.

The $200,000 cap does not apply to other aspects. For example, in a profit-sharing plan where there is a 15% deduction limit, the 15% is 15% of the total compensation, not of the first $200,000 of compensation. In Section 415, employee contributions are not considered to be annual additions if they are less than 6% of all pay under this rule. Voluntary contributions are limited to 10% of total pay, not the first $200,000.

Another question that I frequently get concerns a defined benefit plan which covers a person with compensation in one year of $180,000, the next year of $200,000 and the next year of $220,000. The average three-year compensation on which plan benefits are based is $200,000, but how do I determine that average? In testing for discrimination, do I say the $220,000 year is limited to $200,000, and then use $180,000 plus two $200,000s to get the average compensation? Or, do I simply take $180,000 plus $200,000 plus $220,000 and come up with an average of $200,000? The latter approach may be used. When we test for discrimination on a high three-year plan, the basis of testing will be the average of the high three consecutive years of compensation. That is the basis for the discrimination test.

Revenue Ruling 86-48, which came out on April 7, 1986, came about as a result of REA, and it deals with spinoffs. In a spinoff you deal with benefits on a termination basis, based on the regulations under Section 414(1) of the Code. Those regulations have not changed. Benefits on a termination basis are defined as those benefits which would be provided by the plan assets after the assets are allocated in accordance with Section 4044 of ERISA. REA's anti-cutback provisions make it clear that they apply in the case of a terminated plan, as if the termination were a plan amendment. A plan sponsor cannot eliminate subsidies by plan termination. Having said that, the IRS came out last year with Revenue Ruling 85-6, which referred to a case in which a plan would terminate with surplus assets, if you ignored certain benefits, such as qualified pre-retirement survivor annuities, and if you also ignored subsidized early retirement. All of the surplus was taken back. Under Revenue Ruling 85-6 we said that this was a violation of Section 411(d)(6) of the Code and the exclusive benefit rule, because the anti-cutback rules would not allow you to take back the surplus until you provided for these contingent benefits. Revenue Ruling 86-48 extends Revenue Ruling 85-6's principles, which deal with termination to the case of a spinoff with a Section 414(l) computation. It states that these types of benefits have to be valued in determining how many assets must go to each of the plans. So, Revenue Ruling 86-48 defines the parameters of benefits on a termination basis, to be consistent with the change made under Section 301 of REA.

I've gotten a written question to discuss dealing with a plan covering a self-employed individual. This question considered a plan in which you had earned income in a DB plan of say $100,000, and $110,000 was made in contribution to the plan. And, therefore, the earned income after the change made by TEFRA would be $0. Under the law Section 404(a)(8)(c) would limit the deduction to 100% of the earned income. Now there is a problem with the law as it is drafted. We had discovered that problem shortly after TEFRA passed and the problem is as follows: Suppose that I have this fact pattern and assuming the deductible limit on the 404(a)(1) is high enough that it doesn't impact any of this, and I had $100,000 earned income before. If I contributed $10,000, I get a $10,000 deduction because I get the lesser of $90,000 (the earned income) or the contribution I made ($10,000). If I contributed $40,000, I get a $40,000 deduction. If I contributed $50,000, I would get the lesser of the earned income after the contribution -- ($100,000 - $50,000) or the $50,000 contribution, and that would be $50,000.

So far, the results are not very bad because you got a deduction for everything you contributed. No one in that range is going to be too concerned about it. Then let's take the next step. Suppose I contributed $60,000. If I contributed $60,000, the net earned income is $40,000. I would take the lower of $40,000, following the law precisely, or the $60,000 contribution made. And I get a deduction of $40,000. Now something may be sounding a little funny. What may seem a little funny is that when I contributed $50,000, I got a deduction for $50,000. When I contributed $60,000, I only got a deduction for $40,000. That is, by making an added $10,000 contribution, I ended up losing a deduction of $10,000. Something is wrong. If I had the shear effrontery to contribute $100,000, nothing would be deductible at all.

So this situation needed a technical correction. Along came the technical corrections and there was a change that was made to 404(a)(8)(c) in many of the drafts. And then the story gets murky. Somewhere at the very end someone said "Doesn't this really belong in 404(a)(8)(d) instead of (a)(8)(c)?" Who said it, who agreed to it, or whether anyone was awake at that time, no one knows. However, the correction actually was made to 404(a)(8)(d) inappropriately, and it did not solve the problem. There is now another technical correction because the technical correction needs a technical correction. The IRS indicated that as long as this technical correction is viable (and we suspect that it will clearly pass) we are going to be administering the law as if the technical correction were there. So that, in computing the deductible limit on the 404(a)(8)(c), the limit would be $100,000, not the net. That, of course, is assuming that the 404(a)(1) limit is higher.

Now, my entire analysis was only talking about the deduction limits. There's never been any intent to change the 415 limits. So that high three comp would be net compensation. But the high three comp could have been compensation from prior years. So that you can easily have a situation in which you can have very large benefits that are permissible on a high three consecutive year basis, even though in the current year the deduction is small or nonexistent because of low earned income. But you do have to keep in mind the qualification rules are not being changed. That does become a factor. It becomes much more of a factor in a DC plan.

MR. PARKS: Thank you, Ira. Let me start by asking a question regarding the first topic that you covered, Notice 86-3. I believe it has now been nine weeks since that bombshell was dropped on the pension community, and I am wondering how many plan sponsors have been seeking the relief during that nine week period. And what reactions have field agents who are trying to administer this notice gotten?

MR. COHEN: We don't have any statistics at this point on what the results have been over the nine week period. Our basic statistics have shown that roughly 80% of the plans have actually complied, and do not need the relief at all. This has been based on projections and estimates of how many plans we expect to be amended, and on how many receipts we have gotten. Estimates become difficult because there have been certain changes. For example, in our master and prototype program, we have a new concept of standardized plans, and people who go into standardized plans do not have to request a determination letter at all. This is a tremendous expansion over the number of standardized plans that existed under the previous master and prototype program. So, some of these new figures require estimates.

MR. PARKS: What is a substantive error in reference to applying Notice 86-3. when the plan has been adopted on time but not filed on time?

MR. COHEN: I think a substantive error is any provision that is inconsistent with the requirements of the law. If, for example, the plan provided for the making of distributions to a married participant in a plan subject to the survivor annuity requirements of REA in a form other than a qualified joint and survivor, without providing full consent of the spouse, that would be a substantive error. If on the other hand, the plan provided for many distributions and did provide consent of the spouse but in the way it was drawn it was not totally clear whether the consent applied to one particular provision or not, because the plan was not precisely drafted, we might say this is a clarifying error.

MR. PARKS: IRS Notice 85-5 requires the adoption of DEFRA and REA retirement plan amendments by the last day of the first plan year beginning on or after January 1, 1985. In order to preserve a plan sponsor's remedial amendment period, do REA and DEFRA amendments adopted by the Notice 85-5 date also need to be filed with the IRS district office by this same date, or does the plan sponsor have until the due date, including extensions, for filing the associated tax return?

MR. COHEN: The due date including extensions for filing the tax return applies only to disqualifying plan provisions, as the term is used in Section 401(b) of the Code. A change of law generally is not a disqualifying plan provision. The reason it is not is because a plan amendment did not cause the disqualification. That is, if the plan wasn't amended, it would be disqualified, and if it was amended with this amendment, it would be disqualified. In order to have a plan amendment cause disqualification you would have to have the plan qualified before the amendment, and disqualified after the amendment. In certain limited cases, as in the case of ERISA and TEFRA, we have by regulation defined and expanded the scope of Section 401(b). We have not done this in the case of DEFRA and REA, so the date we are talking about would be December 31, 1985. We had indicated for a long time that we were not going to be extending the Section 401(b) date in the case of DEFRA and REA.

MR. PARKS: Did I understand you correctly to say that under a Revenue Ruling 81-202 test for a plan or plans which are not top-heavy, that the compensation should be limited to $200,000?

MR. COHEN: No. I was talking about situations where the $200,000 limit would apply and that is only in the case of top-heavy plans. If the plan or plans are top-heavy, and you are doing a Revenue Ruling 81-202 test, you would limit compensation to $200,000. If the plan or plans are not top-heavy, you're able to provide benefits on all compensation, and therefore you would not apply a $200,000 maximum on compensation in making a Revenue Ruling 81-202 test.

MR. PARKS: If accumulated annual additions under Section 415(c) are transferred to a defined benefit plan trust, and these transferred assets are used to fund the defined benefit, may the historic annual additions be disregarded for purposes of determining Section 415(e) limits?

MR. COHEN: This is a transfer from a defined contribution plan to a defined benefit plan. Basically, when amounts are transferred they retain the original characterization under the defined contribution plan. I am not sure what happens after the funds are transferred, or how one transfers benefits and funds another benefit as the question suggested. For example, I might have an account balance and I have an existing defined benefit and I am using the assets to fund a defined benefit equal to the value of the account balance. You cannot eliminate the account balance. I do not know whether the funding is trying to convert the defined contribution into a defined benefit. This depends on what the facts of the case are.

MS. CATHERINE L. DROWN: I have a question relating to the mass submitter program. IRS Revenue Procedure 84-23 gave reliance to plans that adopted the mass submitter plans prior to March, 1984. However, plans submitting after March, 1984 did not have reliance.

MR. COHEN: That is correct.

MS. DROWN: I am concerned whether or not mass submitters are expected to comply with IRS Notice 86-3 before I give some details.

MR. COHEN: Mass submitters can be affected by IRS Notice 86-3. IRS Notice 86-3, as we look at it, is a relief provision. If there is a sponsor of a master or prototype plan, and the plan was adopted before March 19, 1984, under Section 12 of Revenue Procedure 84-23 the plan sponsor has a period of time to adopt. That period of time is one year after the sponsor receives a favorable opinion letter and that favorable opinion letter is published in the Internal Revenue Bulletin. We still have roughly 2600 master and prototype plans that have not received opinion letters. When they do receive opinion letters and we publish them, individuals who adopted before March 19, 1984 will have one year to execute the amendment. The date of execution of the amendment is well beyond the dates set forth in Notice 86-3. There would be no penalty whatsoever. Should the plan sponsor adopt the amendment a month late, rather than having its plan disqualified, Notice 86-3 will provide that the sponsor only lose 10% of the tax deduction. For the post March 19, 1984 adopters, the rules and deadlines that apply are the same that apply to individually designed plans. Rather than being totally disqualified, they can take advantage of the relief offered by Notice 86-3.

MS. DROWN: Let me give you a scenario. In March, 1984, the IRS issues Revenue Procedure 84-23 regarding mass submitters. This Revenue Procedure specifically gives reliance, as you mentioned, to those who adopted plans prior to March 19, 1984. On June 17, 1984 a plan sponsor submits a couple of plans under the mass submitter program. The IRS mentions in their data that they expect to have all final mass submitter approvals by September, 1984.

MR. COHEN: Where was the September, 1984 date published?

MS. DROWN: September, 1984 appeared in informal IRS publications. To continue, by September, 1984 we heard nothing. By December 31, 1984 there was no approval, but we had received a preliminary review of one of the two plans. In the spring of 1985 there were extensions of compliance dates. By June, 1985 there was still no approval. In fact, the one plan which was received is returned for amendments to comply with REA and DEFRA. We still had not heard anything on the second plan. In September, 1985 both plans are returned from the IRS after their preliminary (but not final) review. In September, 1985, the IRS extends the compliance date to November 1, 1985. At this point the sponsor contacts the IRS about plans that have adopted after March 19, 1984. The IRS is getting a longer list of them now. The unofficial IRS response is that the IRS is not really concerned with plans under the mass submitter program. It is concerned with the individually submitted plans or the prototypes not under the mass-submitter program. The question from the plan sponsor is: Should we bother submitting these plans for a determination letter when we know the plans do not substantially comply because we have received the results of the preliminary review? What should we do at this point? The November 1, 1985 compliance date has past. In fact, as of April, 1986, we still have no plans. Are we expected to be concerned with Notice 86-3?

MR. COHEN: The point that you started with was that we had indicated that we would have all master and prototype plans approved by a specified date. We had a meeting for plan sponsors after Revenue Procedure 84-23 was issued. At that meeting we made it clear that we might not complete the approval process for some time. Looking at the volume of master and prototype plans (some 19,000 by December 1984), the idea that we would be completing all of them by the date you mentioned would be totally unrealistic. We had indicated at this meeting that we might get to a number of them, but we would not get to all of them. The problem with the plans which were adopted after March 19, 1984 which we also indicated then, is that there is a competitive question: "Should a master or prototype plan be able to seek new business on a plan which may not satisfy all the provisions?" A plan might have lower minimum funding because it does not satisfy all the provisions of TEFRA because the minimum funding for TEFRA is based on what is in the plan. Even when you amend retroactively, you do not retroactively increase the minimum funding, which is governed by Section 412(c)(8), which provides for amendments up to merely 2 1/2 months after the end of the plan year.

This differed from plans which already had reliance; in those plans you don't have major competition. Major competition is occurring on new business. We wanted to give the existing business under master and prototype plans more time, because the process is inherently longer in first waiting for an opinion letter and then getting adoptions and for non-standardized plans, then going for a determination letter. Whereas in the case of new plans we saw a major class of competition. We didn't think it would be fair to say that someone outside of the master and prototype group has to adopt these provisions and have much larger costs, while the master and prototypes could develop new business without adopting the provisions.

MS. DROWN: For those plans which attempted compliance and which did not even receive a response back, or when they did receive a response back, the response indicated they were not substantially in compliance, what recourse did plan sponsors have at that point?

MR. COHEN: They could request a determination letter. That is what we had indicated.

MR. JAMES F. OBERNESSER: I have a two-part follow-up question to your explanation of the $200,000 salary maximum. If I have a top-heavy defined benefit plan that bases benefits on an individual's average pay over his entire career, then if I interpret your explanation correctly, it is only this average that would be limited to $200,000, regardless of the number of years of pay in excess of $200,000.

MR. COHEN: I believe that is correct.

MR. OBERNESSER: The second part of my question is: would a reasonable funding method reflect anticipated increases in the $200,000 limit beginning in 1988?

MR. COHEN: Yes, you could index the $200,000. This is unlike the dollar maximum in Section 415, which was designed to limit deductions, among other things, and was clarified in TEFRA. The $200,000 limit in TEFRA was simply a discrimination issue. If you are funding for a benefit and you anticipate that the cap would be indexed and the results would be nondiscriminatory, I have no objection to funding for that higher indexed amount.

VIEW FROM THE INTERNAL REVENUE SERVICE (IRS)

MR. OBERNESSER: I have heard that there have been some difficulties with IRS offices that have to do with amendments which have been submitted in proposed form and are waiting for the initial IRS review to formally adopt those amendments. I heard this was no longer going to be allowed, or that there had been considerable concern about this practice. Could you comment on this?

MR. COHEN: I am not sure where that information is coming from. We clearly intend to continue the ability to allow an amendment to be submitted in proposed form and then adopted within 91 days after the determination letter is issued.

MS. JOY A. THEOBALD: Consider a situation regarding a collectively bargained plan that, because of the expiration of the contract, does not have to comply with REA until the first plan year beginning in 1986. You mentioned before that Revenue Ruling 82-66 gives relief for submission of TEFRA amendments. How does IRS Notice 86-3 apply to the tax deduction, if a plan sponsor has until sometime later in 1986 to submit the plan to the IRS for TEFRA?

MR. COHEN: TEFRA may or may not be an issue because we have provided in the top-heavy rules that certain collectively bargained plans need not contain provisions dealing with the top-heavy rules. If the plans do not have to contain provisions dealing with the top-heavy rules, you clearly do not need an amendment to reflect them. If you come within those exceptions then you do not have a problem. The collectively bargained plan may be in fairly good shape.

MS. THEOBALD: Are you saying that Revenue Ruling 82-66 may not apply?

MR. COHEN: Revenue Ruling 82-66 will not really apply, or it may apply for employers whose fiscal year and tax year do not coincide. One of the first things you have to decide before you even get to Revenue Ruling 82-66 is whether or not you need an amendment to start with. You may or may not. There are many collectively bargained plans whose benefit formula could not possibly exceed the Section 415 limits. If you do not have an issue on Section 415, you may be in a situation with some collectively bargained plans where you do not have much that you need to do because of TEFRA.

PANEL DISCUSSION

MR. ROBERT H. SELLES: My question relates to Revenue Ruling 81-202. In a situation involving a controlled group, where some members of the group participate in a plan where contributions are discretionary or their participation is voluntary, such as in a 401(k) plan, how does one project benefits for the purpose of testing benefit comparability?

MR. COHEN: I think that one has to make a reasonable assumption as to what future contributions will be. The problem does not only exist in 401(k) plans. It can exist in profit sharing or stock bonus plans as well. The assumptions have to be consistent with past experience. I would have a lot of difficulty if the prohibited group has constantly been making large contributions or large contributions have been made on its behalf, and your projection assumes no future contributions. I do not think that would be an appropriate assumption. On the other hand, if you averaged past contributions and project them into the future, that would be the appropriate way to deal with Revenue Ruling 81-202.

MR. PHILIP T. KAN: This is in regard to IRS Notice 86-3. You mentioned that a submission can be made without execution to stop the clock in order to avoid penalties.

MR. COHEN: That is correct.

MR. KAN: Does it mean you can submit a plan document without it being signed? What does it mean?

MR. COHEN: It means the plan document does not have to be signed. Your forms have to be signed. You don't have to have the plan in place. You can say this is as a proposed amendment designed to comply with TEFRA, DEFRA and REA, and if you give us a determination letter, we will then execute the amendment and take whatever other steps are needed. That is appropriate. There are, in many cases, advantages in going with a proposed, rather than a final amendment. One of the reasons is the anti-cutback rules. If you execute something and find that there is a problem, you may not be able to take it away and there may be greater costs in complying. If you submit the plan as a proposed amendment, and if there is a problem, you may be able to amend the plan without worrying about the anti-cutback rules. You could also execute an amendment but say it is null and void if the IRS finds it bad, then fix it up without worrying about 411(d)(6).

MR. KAN: When we send the plan document as a proposed amendment, does the IRS agent review the plan document and then indicate some parts are insufficient or need changes?

MR. COHEN: Yes, we will review the plan document and issue a determination letter. If there are deficiencies in the plan document, we will contact the plan sponsor and try to reach an agreement on how to fix the plan up. The idea of proposed amendments is something we have done for a long time.

MR. PARKS: In computing the DC fraction for a self-employed individual, do you use the old Keogh dollar limit in the denominator for years prior to TEFRA, e.g. $7,500 vs. $45,475, or treat it as though the parity rules were always in effect?

MR. COHEN: You don't use the $7,500 limit; the prior rules were limitations, but they were not Section 415 limitations. Therefore, you can use the higher denominator and now provide more generous benefits.