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RECENT RULINGS AND REGULATIONS UPDATE -- LATE-BREAKING DEVELOPMENTS

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This session will review rulings, regulations and announcements which have been issued in the last year. This is intended to be an overview and not a detailed analysis.

MR. HARRY CONAWAY: We have two representatives of the IRS Employee Plans Technical and Actuarial Division. Kathy Marticello is assistant pension actuarial branch chief and Carol Gold is group chief, projects branch. Carol will give a regulations update with a discussion of the new rollover and withholding regulations.

MS. CAROL D. GOLD: As Harry said, I'll be talking about the regulations that were published recently on the new distribution rules. Then I will describe proposals that we've made over the course of the summer with respect to the final nondiscrimination regulations and ways in which we might change them. Kathy will talk about our ideas for the determination letter program, what's open now and how things will be open in the future; the examination program; and various administrative initiatives such as the closing agreement program and what we hope will be announced soon -- the Voluntary Compliance (VCR) program.

There are interpretations of changes that were made to the distribution rules as a result of the Unemployment Compensation Amendments Act last summer. Basically that act did four things. It expanded situations in which a distribution is eligible for rollover to another plan. It requires, as a condition of qualification, that plans provide for direct rollover to another eligible retirement plan as one method of accomplishing a rollover. It requires 20% mandatory withholding on eligible rollover distributions that are not directly transferred to another plan and requires an explanation of these rules to employees.

The administrative guidance that was published last week includes temporary regulations and a model notice to employees required under Section 402(f) of the Code. We also hope to have a model amendment out that can be adopted by plans that already have a determination letter bringing them into compliance with requirements of 401(a)(31). It requires plans to provide direct trustee to trustee rollovers.

The crucial element of the new distribution rules is the definition of eligible rollover distribution. Its importance is not just in determining what can be excluded from

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taxable income by rollover, but also what is subject to mandatory withholding if not directly rolled over. Basically an eligible rollover distribution is any distribution from a qualified plan with certain exceptions. A series of substantially equal periodic payments is one of the exceptions to the definition of an eligible rollover distribution as is a distribution required under Section 401(a)(9). Amounts that are not included in gross income are not eligible rollover distributions. And deemed distributions or corrective distributions are not eligible rollover distributions.

In the first category is a series of substantially equal periodic payments. In determining when distributions are substantially equal, disregard the fact that if certain contingencies occur, distributions in the future may be greater or less. For example, a survivor annuity may be less than a joint annuity. Also disregard supplements such as social security supplements that drop out when the employee begins receiving social security. If there's a change in the method of determining the amount of the distribution, a new determination must be made as to whether or not payments are substantially equal. And, if a distribution is made partially as a series and partially as a lump, the lump is an eligible rollover distribution. Periodic payments are payments over life expectancy or over a period of more than 10 years that are paid at least annually. If they are substantially equal, periodic payments are excluded from the definition of eligible rollover distributions.

The second category excluded from that definition is required distributions. Until distributions for a taxable year equal or exceed the minimum required distribution under 401(a)(9), they are considered required distributions and are not eligible rollover distributions. In determining what the minimum amount is for a particular year, a plan administrator may assume that the employee has no designated beneficiary. This will, of course, cause the amount that is considered the minimum required distribution to be larger and, therefore, not an eligible rollover distribution. The employees on the other hand, can rollover any excess that is distributed to them if they do, in fact, have a designated beneficiary.

Any part of a distribution that's not includable in gross income other than net unrealized appreciation (NUA) is not considered an eligible rollover distribution. For example, with respect to NUA, if the single-sum distribution includes a part that is not includable in income because it is NUA, the entire distribution is an eligible rollover distribution.

Finally, deemed distributions or corrective distributions are not eligible rollover distributions. These kinds of distributions are corrective distributions under 401(k), or corrective returns of 401(k) deferrals, or excess aggregate contributions under 401(m), or loans that are deemed distributions under 729(p). Note that if the unpaid balance of a loan is distributed to an employee when the employee terminates employment, that amount is considered an eligible rollover distribution.

Another category of distributions that are not eligible rollover distributions because they're either corrective or deemed, are dividends on employer securities or PS58 costs. Distributions that are received by a beneficiary are eligible rollover distributions if the beneficiary is a spouse or an alternate payee. If the distribution is received by a nonspousal beneficiary, it can't be rolled over and, therefore, is not an eligible rollover distribution. Again, if a distribution is an eligible rollover distribution, it must either be directly transferred by a direct rollover to an eligible retirement plan (for purposes of 401(a)(31) and the mandatory withholding mean either an IRA or a defined-contribution plan that's been amended to receive the rollover), or the amount can be distributed if it's an eligible rollover distribution to the employee subject to the 20% withholding and then rolled over within the 60-day period to an eligible retirement plan as defined in Section 402.

Direct rollover is accomplished by any reasonable method under the regulations. Examples are: a wire transfer, mailing a check to the new trustee or giving a check directly to the employee for delivery to the new trustee. It's important that this be a direct transfer; there are specific instructions in the regulation as to how these payments must be made payable especially with respect to the check that is delivered to the employee distributee. There are specific instructions about how the check should be made out.

The employee can make an election by any reasonable means. The plan administrator can require sufficient information to determine that the transferee plan is an eligible retirement plan. There may be a provision in the plan for default in case the employee does not elect within a reasonable time. Be careful in the case of a default provision if the default is to elect a direct rollover. In establishing the fund to which the rollover would be made, the employer may, in fact, be setting up an IRA that would be a Title I IRA. Again, the default provision may assume that the employee has not elected a direct rollover. The employer can establish a reasonable deadline for making the election, and with respect to splitting the account balance, the employer must permit the employee to split the account balance in a way that would permit the employee to receive a cash distribution and have a direct rollover to another account. On the other hand, the employer is not required to provide an option for the employee to split the rollover between two separate accounts. The employer need only make the option available to have a direct rollover to one account. Once the election is made it applies to a series of distributions as long as the 402(f) notice makes it clear that the election applies to a series of distributions.

If a direct rollover is not elected by the employee, withholding applies. Withholding is a mandatory 20%. It's the responsibility of the plan administrator, although that responsibility can be delegated to a payor. It does not apply to distributions that are expected to be less than $200 during a taxable year. It applies to distributions of property the same way that the rules apply with respect to voluntary withholding under Section 3405 of the Code. In other words, if cash is insufficient to satisfy the mandatory withholding requirements, the option available to the employee is to come up with the cash some other way, either by selling the property or by receiving cash from the employee to satisfy the withholding obligation. The requirement that property be sold or some other method be obtained to meet the mandatory withholding requirements does not apply to a distribution of employer securities. The effective date of these provisions is with respect to distributions, any distribution after December 31, 1992, even if the plan terminated before the end of 1992, even if the distributable event occurred during this year before 1993, and even if payments began before 1993. There's a special transition period giving the 402(f) notice to employees and which provides the employer the opportunity to make a reasonable good faith interpretation of the requirement that they give employees notice of their rights, and the obligation to mandatorily withhold taxable tax on certain distributions.

There's also a transition period for withholding with respect to distributions after December 31, 1992 and before April 1, 1993, if withholding would cause undue hardship on the plan administrator.

The requirements on the employer in all these provisions are, first to give the 402(f) notice to employees. The timing of this notice is that it be given not more than 90 days or less than 30 days before the distribution is expected to occur. This is essentially picking up the rules that apply with respect to distributions under 411(a)(11). Distributions in excess of $3,500 require notice to the employee and the timing is the same as required under 411(a)(11). With respect to a series of distributions, the notice requirement is that it be given only with respect to the first distribution in the series and then at least once a year. A model notice was published recently that can be given to employees to satisfy the employer's obligation to give notice; that model notice may be customized in certain ways by eliminating provisions of the model notice that are not relevant with respect to a particular employee or employer.

The second requirement for employers is that they amend their plans to provide for the direct rollover, and that amendment has to be made by the end of the 1994 plan year. The amendment has to permit a direct rollover election. However, it does not have to permit a receipt of rollovers from other plans.

The third requirement for employers is a reporting requirement. All distributions have to be reported on a 1099R. An IRA has to report a received rollover on a form 5498. A plan that receives a rollover transfer does not have to report the rollover. That summarizes the distribution rules.

MR. CONAWAY: I have a series of questions on Carol's comments. Perhaps the big issue in the regulations is the application of the 30- to 90-day advanced notice requirement. As Carol mentioned, the regulations really piggyback on the 411(a)11 requirement that an advance 30- to 90-day notice be given prior to any distribution. The IRS can fairly point out that the rule was already in effect. If many plans were satisfying the rule, there would be no problem with the new rollover withholding rules, but there's a more general problem. The regulation indicates there's a willingness to reconsider these rules.

Here is an example of where the problem comes up. Assume in a defined-contribution (DC) plan, an employee separates from service in November. Let's say the valuation date is the end of November, so the amount of the individual's account balance, the amount that will be distributed, is fixed at the end of November. Then, the individual receives the check in January.

I think employers in plans would prefer that the 30-day period runs from the date the check is distributed. It's not the date of seperation from service. There's a feeling playing off the rules as they apply to pension plans, defined-benefit (DB) plans, and the annuity starting date, which is the "as of" date and not the actual date of receipt of the first check, you have to give the notice at least 30 days before November 30. In this case it would be the valuation date which, obviously, would make it impossible to value this individual's account on November 30. You can't fix the amount of the distribution until 30 days after notice is given. If an individual leaves in November and the employer gives the notice, then a December 31 valuation date is needed for this individual. So the rules aren't entirely clear, and there is concern about the application of the rule.

MS. GOLD: I agree. The application of these rules that were developed in the case of pension plans that are subject to the notice requirements under 401(a)(11) and 417 were developed to give employees enough time to make a decision without pressuring them into a decision. There are decisions that have to be made. The use of these particular timing requirements might not fit, and that's why the request for comments was made.

MR. CONAWAY: Obviously, in-service withdrawals would be a potentially adversely affected process. Some employers are going to voice response and with this processing of withdrawals can occur in less than two to three weeks. As long as the 30-day rule is complied with as it currently stands, the distribution can't be made that fast. Can an employee waive the 30-day notice?

MS. GOLD: Perhaps. I'm not sure whether the preamble or the regulation indicates the employee has the option to waive the 30 days. Once the notice is given 30 days before the distribution is expected, the employer doesn't have to wait 30 days before making the distribution.

MR. CONAWAY: I thought on mandatory distributions you could have a consensual waiver, but on a nonmandatory group (above $3,500) there wasn't a similar paragraph in the preamble, therefore people are concerned. The implication is you can't waive. Are you familiar with plans that aren't currently complying with the 30-day notice under 411(a)(11)? I find more plans don't comply than do comply.

FROM THE FLOOR: Why is there a requirement for distributions under $3,500? I can understand mandatory withholding, but not the notice period.

MS. GOLD: It's just to give the employee the option of avoiding the withholding tax on the distribution.

FROM THE FLOOR: I understand that, but my little plans cry already. Of course, I'm the messenger who brings the bad news. The attorneys prefer that I do it.

MR. CONAWAY: I believe your argument is with the statute and not with the regulation.

MS. GOLD: There's no exception for the mandatory.

MR. CONAWAY: I think the regulation includes a $200 de minimis exception.

MS. GOLD: That's right.

MR. CONAWAY: And the technical corrections would include a $500 de minimis exception; they don't provide the $3,500 as an exception.

It is suggested that an employer can satisfy this regulation by just repeating the notice requirements on the back of something he is ditributing already and sending it out every 60 days to all participants.

MS. GOLD: Some felt that that would be an acceptable way of meeting the notice requirement. On the other hand, the reason for the 30- to 90-day notice requirement is to bring it to the attention of the employee who is about to receive a distribution at a time when it is relevant to him. That's the other side of the coin, although within the walls of the Service, there were two sides on that one.

MR. CONAWAY: The 402(f) notice is not itself a qualification rule. I've talked to several people who weren't losing any sleep when they weren't complying with 411(a)(11), which was a qualification rule, so they're not going to be any more restless at night when they fail to satisfy something that's not a qualification rule.

It's worth emphasizing that a direct rollover can be accomplished by simply providing the employee with a check that can be negotiated only with an IRA or a plan trustee. This makes it far simpler for many plans to comply with the new rules. They won't have to change their basic distribution process. One question in the direct rollover context is after the employee gets the check, does he have only 60 days to then take the check to the IRA or the plan?

MS. GOLD: No, there's no 60-day requirement, although it's certainly to the employee's advantage to get that money into some kind of earning situation as quickly as possible.

MR. CONAWAY: Another area is with loans, the difference between defaulted loans and unpaid loan balances at the point of distribution. The rules make it clear that defaulted loans are not eligible rollover distribution so there wouldn't be a withholding requirement and the amount of the default can't be rolled over. However, the unpaid balance on a nondefaulted loan at a separation from service is an eligible rollover requirement.

For example, assume that an employee terminates up to $10,000 gross account balance, $2,000 of which is part of an unpaid loan, and the other $8,000 is in cash. The plan doesn't technically default the loan on separation from service but rather distributes the unpaid note of the employee. How much can the employee directly rollover say to an IRA? Assume that the employee can't rollover the unpaid notes since an IRA can't in effect make a loan to a beneficiary. There's a withholding obligation on the full $10,000 to consider.

There seem to be two answers at least. One is that the employee has a right to do a direct rollover of $8,000. That leaves the unpaid note subject to $400 withholding which the employer and the employee have to satisfy somehow. The alternative approach is that the employer withhold $500 from the $8,000 amount. That leaves $7,500 for the direct rollover and $500 withholding. The $500 withholding is the 20% of the $2,000 note, plus $500 withheld. Where is the IRS on this?

MS. GOLD: I think the answer is that you can only roll over $7,500; withholding $500 becomes kind of circular as Harry notes. You have to count the fact that you're withholding which then becomes subject to withholding itself.

MR. CONAWAY: So the total distribution in this case is an eligible rollover, not just $8,000.

You have to withhold. Don't withhold 20 cents of every dollar; withhold 20% of the entire amount. The only exception I guess is where you don't have to sell employer's stock, for example, to satisfy withholding. Because you didn't have to, in effect, sell the unpaid note, it is an exception.

There's a tax game that has been raised as a way to avoid the pro rata basis recovery rule for in-service distributions. The idea is to take an in-service distribution, keep the basis, and roll over the taxable portion, essentially getting basis first and retaining the taxable portion in a qualified plan or an IRA for continued tax-free growth. Was this possibility considered by the IRS?

MS. GOLD: I suppose it certainly was a possibility.

MR. CONAWAY: The same sort of transaction can be done to avoid the 20% withholding: do a direct rollover to the IRA and then the next day take the money out of the IRA. Can an employer comfortably advise employees about these possibilities? Some argue that employers or fiduciaries are under an obligation to advise participants and beneficiaries of these sorts of things. The risk is that the IRS might somehow collapse the transactions and cite it as a failure to satisfy the rules.

MS. GOLD: Making the distribution or the direct rollover to the IRA and then taking the money out of the IRA the next day is really a statutory loophole that we have been aware of. Unless there's a statutory change, we can't prevent this.

MR. CONAWAY: Several years ago in one of the pension portability bills there had been the rule permitting rollovers of in-service distributions. That was eliminated in the statute in that legislative session because of the ability to beat the pro rata basis recovery rules. Frankly, it surprised me that it was permitted in this legislation again. So I think there is at least an argument that Congress or some in Congress at least were constructively aware of this potential when they adopted the statute.

The effective date is an important thing to keep in mind here. The new rules apply to the distributions on or after January 1, 1993, even if the event giving rise to the distribution occurs in 1992. Employers and plans need to make decisions in 1992 given the 30- to 90-day advance notice requirement about when to stop processing distribution requests, distributions under the old system, and when to begin using the new rules. The issue I discussed earlier with the lump-sum and the profit-sharing plan, obviously, is an interpretation of how to apply the 30-day period, particularly in terms of the effective date.

May a plan that provides for distributions in cash and stock limit their direct rollover just to cash so it doesn't have to directly transfer the stock?

MS. GOLD: If the distribution is a mix of both, I don't think so. Bear in mind though that the employee can decide to make a direct rollover of only part of their account.

MR. CONAWAY: Where an employee requests distribution, does the regulation require that the IRA, say in the direct rollover situations, actually be set up where the employer cuts the check and makes the distribution or is that not necessary?

MS. GOLD: The regulation does not require that.

MR. CONAWAY: Can an employer enter into an arrangement with a bank on a default procedure basis and say, "My employees request distributions. If they don't request a particular IRA, I'm going to automatically establish an IRA in the name of that individual with bank X." Is that procedure permitted under the regulation?

MS. GOLD: I think it's permitted. First, there is a default procedure if the employer doesn't get sufficient information from the employee. A specific provision in the regulation allows the employer to establish a default if they don't get an election from the employee. Be aware of the fact that the employer establishing the IRA may, in fact, be establishing a plan that's subject to Title I of ERISA.

MR. CONAWAY: You could create the default so that there's a distribution, too. It doesn't have to be that the default is a direct rollover to an IRA but make a distribution a default as well.

MS. GOLD: Right.

MR. CONAWAY: Regarding the notice that Carol mentioned, it's important that an employer or a plan shouldn't just automatically adopt the notice as its own. There are certain decisions that an employer should make in terms of whether it wants to tailor the notice to its particular situation. There are a number of permissive rules in the regulations and those issues should be addressed in tailoring the notice. For example, does the employer of the plan want to take advantage of the $200 de minimis rule for direct rollovers? Should the employer limit the employee's ability to defy the distribution into a rolloverable amount and a distributable amount? That's a permissive rule. Should the employer or a plan honor elections dividing a direct rollover among two or more eligible retirement plans or IRAs? It doesn't have to, but it may allow individuals to rollover to more than one IRA, for example.

Carol mentioned the decision to apply an election to a series of payments or just to one distribution. That's an elective provision. The notice takes the view that it applies to the series of payments, and the employer can modify that if it chooses. Does the employer want to adopt a default approach where there's a failure to give an election?

The technical corrections contain three other important rules that are not reflected in the regulations. First is the $500 de minimis rule which the regulations did not adopt. Second is the exception for hardship distributions, which are not exempt from the eligible rollover rules as applied under the IRS regulations. Third, there was a significant grandfather of benefits accrued as of a particular date. How did that work?

MS. GOLD: I'm not sure.

MR. CONAWAY: The effective date applies to all distributions on or after January 1, 1993. There is not a grandfather in the regulations. So if you were expecting all of the technical corrections in HR-11 to be adopted, be aware that the President hasn't signed that bill yet. After the election, if he doesn't sign, or vetoes the bill, then those three areas are the primary three technical corrections that are not reflected in the IRS rules. So if you were assuming that they were going to be law, you should rethink that assumption.

MR. LEONARD WEAVER*: I want to make sure I understand the minimum distribution of $200. If I get a distribution of say $2,400, $2,200 of that represents my own contributions. Does it come under the minimum rule?

MS. GOLD: Technically that doesn't come under the minimum rule. I think the minimum is $200, a flat $200 during the year. Now to summarize the proposed changes to the nondiscrimination regulations. The nondiscrimination regulation package was published and finalized a year ago and the regulations were to have been effective in 1992. The effective date was deferred early in 1992, and recently the Service and the Treasury confirmed an extension for the nondiscrimination regulation package to plan years beginning in 1994. At the same time, the remedial amendment period under 401(b) was extended to the last day of the 1994 plan year; this extension also applies to new plans adopted after 1987.

At the same time, Alternative 2D also was extended. Alternative 2D under Notice 88-131 provides plan sponsors additional time to make decisions about retroactive plan changes that might be necessary or desirable as a result of amendments to the qualification requirements. Alternative 2D generally provides that beginning in 1989, benefit accruals that no longer meet the qualification requirements can continue under plan provisions because of statutory changes that became effective in 1989. The notice extending the remedial amendment period and extending the relief under 2D provides that accruals under 2D won't be tested in the general test when the nondiscrimination regulations become effective in 1994. They also will not keep a plan out of a safe harbor.

A final provision in the notice extending the remedial amendment period is that although benefits, rights and features cannot be added retroactively to a plan under the general rules, they can be added by the last day of the remedial amendment period. This extension provides employers, industry representatives and practitioners time to think about the ways in which these regulations do or do not fit within their own planning, and it gives us time to respond to their comments.

We met with a number of groups and received numerous comments on ways in which the regulations could be modified to reduce the burden and to increase access to safe harbors. We've proposed a number of solutions. These have been proposed

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in notice form, and you can expect this notice of proposed changes to be incorporated in a proposed regulation that would modify the final 401(a)(4) regulation. That proposed regulation incorporating these proposed changes is in the final draft stages. The proposed solutions are to relax the uniformity provisions for safe-harbor plans, to permit increased flexibility in those uniformity requirements, and to make a number of changes to the general test to provide service and compensation credit for service outside the control group. It relaxes the fresh start rules, expands the grouping provisions and provides a facts-and-circumstances safety value. The fourth proposed change was issued in the form of a proposed revenue procedure. It indicates the kind of data that will be required in order to demonstrate compliance with the nondiscrimination provisions.

First, let's discuss the proposal that increases access to the safe harbors by making the uniformity rules more flexible. Usually, safe harbors avoid the general test calculation of individual-by-individual allocation or accrual rates. In return, and to avoid abuse of the safe harbors, plans have to follow certain rules that standardize the way benefits accrue under a plan vis-a-vis uniformity requirements.

There are certain requirements; for example, the benefit formula must be uniform and subsidies must be uniform. The changes that are proposed with respect to access to the safe harbors are to drop the requirement that service crediting and vesting schedules be the same. The service crediting method and the vesting schedules under the proposal would be subject to a general facts-and-circumstances antiabuse test. There's also a proposal to allow credit within the plan for service outside the control group if that credit is granted for legitimate business reasons, and similarly situated employees are treated the same. Generally, the service crediting would be either preparticipation service (in the case of a merger or acquisition) or service after the employee leaves the control group but remains connected with the employer (in a case where the employees transfer to a joint venture).

Fresh-start rules in the safe harbors are proposed to be modified to enable employers to make changes in the benefit formula after the regulatory effective date and, in particular, to accommodate merger and acquisition situations to allow compensation upticks regardless of whether or not the fresh start comes after the regulation's beginning date. The compensation upticks would be subject to rules that are currently in the transition rule that require a provision of meaningful benefits on an ongoing basis. One of the ways to provide meaningful benefits is to cover a 410(b) group for a period of five years. In the case of mergers and acquisitions, the merged or acquired group could be a separate fresh-start group for purposes of fitting within the safe harbors and there is a requirement that the group meet 410(b) anytime within the 410(b)6(c) transition period for mergers and acquisitions.

Another change to the safe harbors is the proposal of a primary insurance amount (PIA) offset safe harbor. Historically, employers have been able to take credit for making contributions to social security and demonstrating that the planned benefits are not discriminatory. One method is to draft a plan benefit that provided a dollar amount offset by a percentage of the social security PIA. Tax reform changed the permissible offset by tying the maximum offset to covered compensation. A plan that incorporates covered compensation offset as a cap on what is otherwise a PIA offset and fails to meet the uniformity requirements of 401(l). Compliance with

401(a) is the ticket to the use of the safe harbors under 401(a)(4). Thus, PIA offset plans have no access to a safe harbor. Plans with PIA offsets typically easily passed the general test but demonstration of compliance was expensive. So Notice 92-32 proposes a PIA offset safe harbor under which the PIA offset is limited to the maximum 401(l) offset. It incorporates the rules under 401(l) with respect to determining the maximum offset. If the plan meets one of the safe harbors within the 401(a)(4) regulations, it will be deemed to meet the uniformity requirements for use of the safe harbors.

In addition to proposing changes to the safe harbors, we've proposed changes to the general test under the nondiscrimination regulations, principally with respect to crediting service and compensation in a manner similar to the way in which we proposed increasing access to the safe harbors. In other words, in calculating accrual rates the regulations will allow credit for service and compensation under certain circumstances in which employers are related in a practical business sense. For example, in a merger or acquisition situation, preparticipation service can be granted with perhaps an offset. For leaves of absence for work with a joint venture, credit for service or imputing compensation for purposes of compensation increases in a final average formula could be accommodated.

One of the requirements for service and compensation crediting is that if credit is granted for some highly compensated employees, the same credit has to be given for nonhighly compensated employees in similar situations. Credit can, however, be given on a transaction-by-transaction basis. There has to be a legitimate business reason for granting the credit, and this can be based on the degree of business ties between the employer and the entity outside the control group. There's the facts-and-circumstances test that requires the credit granted be nondiscriminatory. One of the factors that goes into meeting this facts-and-circumstances test is that the credit be a provision that attempts to make the employees whole and not harm them for what otherwise are good business decisions. Other factors include: the degree to which the plan passed coverage; whether or not reciprocal credit is given by other employers; the type of service that's granted; and whether or not it's only the most highly compensated employees who are given this service or compensation credit. Again, this would be similar to the relaxation of the fresh-start rules that are provided in the access to safe harbors.

The third proposal is to expand the grouping requirements under the grouping rules. The most valuable accrual rate under the final regulations was to have been 5% on either side of a midpoint. In the proposal, that margin is expanded to 15% on either side of a midpoint, in which case all accrual rates within that margin could be considered one accrual rate at the midpoint for purposes of determining whether or not the rate meets the 410(b) coverage tests.

Also, a facts-and-circumstances safety valve is proposed. A number of employers indicated to us that a plan might inadvertently, in some years, slip out of compliance with the general test because of unforeseen circumstances. We proposed a safety valve in which a plan would be able to pass the general test if it excluded no more than 5% of the highly compensated employees and treated them as not benefiting.

This is to accommodate unusual circumstances. There would be a facts-and-circumstances test to demonstrate that the plan is nondiscriminatory. Among the factors would be: (1) the extent to which the plan failed to meet the general test; whether or not the failure was a result of plan design; (2) whether the highly compensated employees that are considered not benefiting under this safety valve are not the most highly compensated employees; (3) whether or not the benefits that cause a failure are benefits that were accrued under a prior formula or while the highly compensated employee was a nonhighly compensated employee; and (4) whether the failure is in the determination of the most valuable accrual rate as opposed to the normal accrual rate.

The final change that's proposed with respect to the general test is to eliminate objective testing in the provision of benefits to former employees and, again, to subject that to a facts-and-circumstances antiabuse test.

The proposed revenue procedure with respect to data deals with several problems. The first problem is determining the quality of data necessary to demonstrate compliance with nondiscrimination requirements. The concerns are a result of the nature of the general test which focuses on individual accrual rates. Employers brought to our attention that they generally have two kinds of data: valuation-quality data, which is not necessarily done on an individual-by-individual basis, and benefit quality data, which is retrieved perhaps once in an employee's career when he or she is eligible for a distribution. They led us to believe that the time and expense involved in retrieving benefit-quality data was exorbitant and could not be used to demonstrate compliance with the nondiscrimination requirements. So, the proposed revenue procedure establishes the concept of substantiation quality data. These are the best data available at a reasonable expense that would enable an employer to reasonably conclude that demonstrating compliance with a nondiscrimination requirement establishes a high likelihood that he will pass using precise data.

A second provision in respect to snapshot data testing enables an employer to pick a representative day within the plan year in order to establish its testing population. Then, the discrimination testing is done with respect to that snapshot population. We expect, for defined-benefit plans, the date the employer collects valuation data will also be the snapshot testing day provided it's reasonably representative. The date when substantiation quality data are gathered will often be the date valuation quality is gathered.

A third provision enables employers to determine, early in the plan year, who their highly compensated employees are. You can determine who your highly compensated employees are within the snapshot population on the snapshot day, the single representative day. If that day is early in the year, approximate compensation for the year by projecting. Use this method to determine who your highly compensated employees are for purposes of determining who they are when running the 401(k) test.

The final proposal in the proposed revenue procedure on data is to establish a three-year testing cycle that will enable an employer to rely on the testing results from one year for the next two succeeding years if there are no significant changes in the employer's situation. Changes that might be considered significant are changes in the work force composition, plan provisions, or compensation practices. But they will only be significant if, when looking at the margin by which the employer passed the nondiscrimination requirements, the change will eliminate the margin of passage.

MR. CONAWAY: It is rumored that some people at the IRS felt that some of the changes weren't necessary to make the rules workable. Can people expect that the regulations will be narrow reading or tightening of the rules outlined in the notices, or do you foresee that the proposed regulations will fairly reflect the proposals in the notice?

MS. GOLD: The regulations will reflect not only what's in the proposals, but also a number of other issues that have been brought to our attention that don't really require change, but are of a technical nature.

MR. CONAWAY: Nobody, the IRS included, can really tell how an idea will work until he or she sits down and tries to do a redraft and put in the context of a full regulation to see what all the relationships are. So it was in a notice, but once you put it into a regulation, see how it actually relates to other provisions, you might find that there were things that you did that were more generous than maybe you intended to do. If there is a President Clinton, he will have certain proposals. For example, his 1.5% of payroll job retraining proposal. He requires, as part of that, satisfaction of a nondiscrimination rule. He has similar proposals in the bonus area and in the severance pay area. So there was concern expressed by some that, under President Clinton, there would be more sympathy, shall we say, towards tougher discrimination rules.

MS. GOLD: My perspective on the changes to the regulations is that what we started with was a very precise package of objective rules. What's been changed are some of the ways in which those objective rules impede normal business practices. I don't think that there's a real change in the philosophy of adhering to the nondiscrimination principles.

MS. KATHRYN G. MARTICELLO: Regarding PIA offset plans, some employers were not entirely satisfied with the proposal in the notice. From our standpoint, it would be difficult to change what we've proposed without an accompanying change to the statute because of the two-for-one rule.

MR. CONAWAY: How about cash-balance plans? As part of the assumption, there's a requirement that a hypothetical account balance grow to normal retirement age by using a current interest rate, or one that had been some average of the last three or maybe five years. The effect that this could produce -- it doesn't produce it now because interest rates are so low -- is that using one rate to project and coming back using a lower PBGC rate, thereby requiring a cash-balance plan, at least in a safe harbor context, to pay out in a lump sum, more than the hypothetical account balance.

I've received questions about whether there will be some modifications to the safe harbor. Will the requirement that the accrued benefit of the normal retirement benefit in that cash-balance plan, whether or not it's a safe-harbor plan, be determined by the same interest rate methodology applying that current interest rate to age 65?

MS. GOLD: There was at least one recent meeting with various representatives from private industry, and we discussed this so-called 417(e) issue. The Service is certainly aware of the problems that can happen when you essentially have to top off the distribution. Assuming the PBGC rates continue to be calculated as they are, the problem is going to continue. We're aware of it and we're considering it.

MR. CONAWAY: The concern is how to determine the accrued benefit in a cash-balance plan and state it as a normal retirement benefit commencing at age 65. What assumptions have to be used so that it's not limited to just discrimination analysis, and it's not necessarily just a lump-sum distribution problem?

MS. GOLD: Someone did submit a plan to us where the accrued benefit was calculated by going forward at the PBGC rate and coming back with it. Each year's accrual was actually computed so that the cash-balance amount would always be equal to what would have to be distributed if you came back.

MR. CONAWAY: So they didn't key the earnings of the hypothetical account to T-bills or something. They keyed it to the PBGC rates.

MS. GOLD: That's right.

MR. CONAWAY: So it came back at the same rate.

MS. GOLD: Well, each year they tried to take account of the change in the PBGC rates. I won't go into them here, but there were various other technical issues that came up because of this attempt.

MR. CONAWAY: The last designs that I get questions about are age-weighted defined-contribution plans. People are asking whether those will continue to be treated favorably. I think some expect, even though they are favored under the current regulations, a reduction in the interest rate that may be assumed in cross-testing these plans.

MR. WILLIAM B. GULLIVER: A number of my clients have undergone general testing procedures for existing formulas which are not safe harbors and where problems exist. What's the remedy? Very often that leads you to a discussion of formulas which accrue substantial benefits for low-paid people in their early years of service because those are very valuable accruals with a very low cost. You can then introduce disparity in the formula for high-paid people by increasing benefits for low-paid people that have a relatively low cost. It would be very unfortunate if many companies used the general testing procedure as a mechanism for introducing low-cost benefits for short service and used low-paid people as a way to support formulas with disparity in favor of high-paid that far exceed anything in the safe harbors. Is the Service aware of those kinds of remedies, and would the Service be uncomfortable with a formula that exceeded safe-harbor disparity if, in fact, it passed a general test with these kinds of remedies?

MS. GOLD: Yes that's where we are with objective testing.

MR. CONAWAY: Do the final regulations have an overriding antiabuse rule?

MS. GOLD: In one of the regulations there's an antiabuse override. It is to be invoked in really egregious situations.

MR. CONAWAY: You front-load significant accruals knowing that most of those people are going to break from service before five-year vesting. But there isn't an objective way to apply that rule. It's the sort of thing I would expect if it becomes a problem. In the IRS's view, it's a topic for a revenue ruling or something down the road.

MS. GOLD: Right.

MR. CONAWAY: Okay, Kathy, we'll turn it over to you for the determination letter program.

MS. MARTICELLO: I'd like to give you an update on our program status. I'm going to talk about three things: the determination letter program, our examination program, and some of our additional compliance programs, for example, our closing agreement program (CAP) and what we hope will be released soon, our new VCR program.

The effective date of the nondiscrimination regulations has now been postponed through 1994, and the remedial amendment period and the relief provisions in Notice 91-38 have been extended through 1994. Some sponsors may want to wait until the regulation package is finished to amend their plans and request determination letters. However, there are a lot of sponsors right now who can come in and get a determination letter based on the provisions of Revenue Procedure 91-66 and the program expansion that we issued earlier this year in Revenue Procedure 92-60.

Who can request a determination letter? Nongovernment plans, plans that are not described in Code Section 414D, may request a determination letter with respect to all of the provisions under the Tax Reform Act (TRA), even the ones that have post-89 effective dates provided that they're not asking for reliance on the package of nondiscrimination rules that was deferred to 1994, specifically, Section 401(a)4, 401(a)17, 401(l), 410(b), 414(r), and 414(f). Other requirements under Section 401(a)26; requirements under Section 411(a), the new vesting rules; Section 415; Sections 401(k) and (m) based on the package of regulations that were issued earlier this year; and Section 401(a)9, required distribution rules.

If a plan sponsor requests a determination letter in these circumstances, a caveated letter will be issued that will specifically say there's no reliance on the basket of deferred nondiscrimination rules that haven't become effective yet. So that would mean the plan sponsor would have to reapply once the final package was out. Similarly, government plans that are described under Section 414(d) can now come in and request a letter that takes into account everything except the package of deferred nondiscrimination rules as they apply to government plans. These plans also would receive a caveated letter that would state that reliance was not granted with respect to those provisions. They would have to come in for another letter when the provisions were finalized. Plans that do not benefit any highly compensated employees are eligible to come for a determination letter on all of the requirements now.

The plan must demonstrate that no highly compensated employees are covered. The plan must also demonstrate that Section 401(a)26 requirements are satisfied. The letter will not contain a caveat. It will be a noncaveated letter. However, the letter may not be relied upon with respect to whether or not former employees satisfy any of the nondiscrimination rules.

In addition, the sponsor will have to reapply if any change in facts and circumstances occur. For example, if any employees suddenly become highly compensated employees then the facts have changed and you don't have reliance on your letter. Alternatively, plans that satisfy the rules in Revenue Procedure 91-66 can certainly apply for a determination letter. Revenue Procedure 91-66 states that plans that satisfy a nondiscrimination design-based safe harbor may receive a determination letter that takes into account all requirements under TRA 86, even the ones for post-1989 years.

Now Revenue Procedure 92-60, expanded Revenue Procedure 91-66 which didn't cover stock bonus plans, employee stock ownership plans (ESOPs), 401(k) employee salary deferrals matched through ESOPs (KSOPs), and HSOPs. Now stock bonus plans ESOPs and KSOPs may come in for determination letters. Also, 401(k) plans can come in for determination letters based on the package of regulations that were issued in the summer.

With respect to prototype plans, the program is now open to a wide range of defined-contribution plans including target benefit plans. Revenue Procedure 92-41, which was issued earlier this year, applies to master and prototype plans, regional prototype, and volume submitter defined-contribution plans which receive favorable letters after January 1, 1990. That revenue procedure provides a simplified method for these plans to be amended to take into account new rules under 401(k) and (m) and a new definition of compensation under Section 414(s).

The Service is currently thinking about establishing a new type of prototype plan, a nonstandardized safe-harbor plan, and this vehicle will provide some flexibility with respect to options for contributions and benefits. But all the options would have to satisfy design-based safe harbors.

With respect to the general opening of the determination letter program, we would hope to have the program opened by the end of the good faith period. We would also like to afford a little more flexibility in the program if we can. There's the possibility that the program could be organized around the concept of core and noncore issues. Core issues would be form requirements and certain traditional requirements that have always been taken into account for determination letter purposes. For example, coverage. Those requirements would automatically be considered when you came in for a determination letter and you would get reliance in your letter for those issues. However, if there were other things that you wished to have the Service consider and you requested that the Service consider, then you could expand the reliance in your determination letter.

With respect to the examination program, let's discuss the small-plan audit program. As most of you are aware, Judge Clapp's decision in Tax Court was handed down on the Vinson & Elkins cases, the Wachtell Lipton case, and the Phoenix cases regarding actuarial assumptions. Are they reasonable for purposes of calculating the costs and deductions? The results were adverse to the Service. Currently, Service Counsel has been working on an analysis of the issues involved in our appeal options, and we will be working with the Justice Department to provide recommendations as to whether or not an appeal will be undertaken in those cases. Of course, the final decision is up to the Justice Department. Meanwhile, the Actuarial Resolutions Program has more or less ground to a halt. If you want to get in, it's too late. The program ended during the summer.

We're moving in new directions in our examination program. Some of the emphasis will be only underfunded plan exams. The Service is embarking on an underfunding study that will be conducted at the national office, and a companion Underfunding Exam Emphasis Program. We will be looking at underfunded plans with technical noncompliance problems. For example, we will be looking at plans that have large funding deficiencies. We'll be looking at plans that have received waivers of the minimum funding requirements where the waiver ruling letter may have been conditional on certain events taking place. We'll be looking to see whether the conditions have been satisfied. If they have not, the waiver ruling letter is no longer valid. We will be looking at plans that are substantially underfunded because these are the plans that are of such concern both to Congress, the public, and government agencies (for example, the PBGC). So we really want to scrutinize these plans to try to find out if we can avoid some of the problems that the PBGC has experienced recently with terminations of big plans in the steel and airline industries.

For the Underfunding Study, which will draw on the data that we get from our Examinations Program, we'll be trying to identify areas of technical noncompliance. Where are the problems in satisfying the funding rules? Second, when we identify those areas, we will try to use that information to improve our examination and auditing techniques, and maybe improve the guidance that we give to the public so that we can try to improve voluntary compliance in this area. When we find issues that are not responsive either to better auditing techniques, education, or additional guidance, then we will try to formulate some legislative or regulatory solutions if we can. We will also be looking at possible prohibited transactions, and we will be looking to see whether assets are appropriately and timely valued in pension plans.

The third emphasis area that we'll be looking at are 412(i) arrangements. We will be looking specifically at 412(i) arrangements that are plans exclusively funded using annuity contracts. We will be looking at some of the instances where a trusteed plan is converted to a 412(i) plan. Sometimes there is a very large contribution required to effectuate the change. We will be looking to see if this contribution is subject to the deduction limitations under Section 404. We'll be looking to see whether those limitations have been satisfied. We'll also be looking in Section 412(i) arrangements to make sure that the 415 rules which apply to those arrangements are being satisfied. For example, are all the distributions under these arrangements limited in a way that Code Section 415 requires?

The fourth area that I want to talk about is other compliance programs. We're expecting to announce a new voluntary compliance program very soon. The VCR program will be a temporary, experimental program designed to encourage plan sponsors to correct operational defects in their plans and to implement administrative procedures that will keep their plans in future compliance. While a plan sponsor can obtain an advance determination that the plan document satisfies the qualification rules, there is no similar insurance policy for operational defects. Your plan can be examined and disqualified because of an operational defect.

The Service currently has two programs that enable a plan sponsor to correct operational defects short of disqualification. One is the administrative policy regarding sanctions. This treats very minor operational defects occurring in not more than one single plan year. In other words, this treats an isolated minor occurrence not meriting disqualification if correction is made.

The second program, the closing agreement program, treats more significant qualification defects. CAP requires the plan sponsor to enter into a closing agreement with the Service and pay the treasury an amount based on the tax we would otherwise collect, adjusted for equitable considerations. This program is available to plan sponsors under examination and also has been offered to plan sponsors that voluntarily come to the Service. A number of plan sponsors have indicated that they would like to correct operational defects, but they're reluctant to approach the service under CAP. This may be because of the combined cost of correcting the plan defects and paying a monetary sanction to the IRS; hence, the VCR program was created.

Under the VCR program, the Service expects to invite plan sponsors to voluntarily disclose a list of their operational plan defects, and to pay a fixed compliance fee. There's no negotiation. The fee is fixed. They also must agree to make full correction, and in appropriate cases, implement administrative procedures that will keep the defect from occurring in the future. Full correction entails the correction of all defects for all years in which the defects exist. The compliance fee will generally be based on the size of the plan, the amount of assets, or the number of plan participants. We expect the VCR program to be available only to a plan sponsor that is not under examination. A plan sponsor who is under examination has access, of course, to CAP. In general, we expect the VCR program to be available to plans with operational qualification defects. However, like CAP, the Service will probably not give a compliance letter under the VCR program to a plan that has exclusive benefit violations, or flagrant and deliberate violations, or has not been amended for TEFRA, DEFRA, or REA. In general, violations that are subject to excise tax, for example, minimum funding violations, will not be covered under the VCR program. There are some defects, for example, a 401(k) defect or a 401(a)(9) problem where there's an excise tax and a qualification problem. In that case it might be possible to approach the problem in two different ways and solve the two problems simultaneously through closing agreement arrangements and VCR arrangements. Because this would be a voluntary program, the Service would examine the plan only for operational defects raised by the plan sponsor. The plan sponsor is responsible for disclosing the full extent of the defects. We're not going to go out and find the defects. The compliance letter will address only related issues and other issues that arise in the discussion between the Service and the sponsor. So if the plan sponsor receives and complies with the terms of the letter, then the plan sponsor is protected with respect to the issues that have been reviewed and I think that's just about it for the VCR program.

MR. CONAWAY: You said the IRS won't raise operational defects?

MS. MARTICELLO: Well, this is a plan that's not under examination.

MR. CONAWAY: Is there any interplay between the plan sponsor and the IRS in this example: Say I'm a plan sponsor and I list 10 defects, but I'm not sure about three of them. There are two others that I think might be theirs. Is there an opportunity to sit down with the IRS and discuss whether this is a violation or not?

MS. MARTICELLO: I am conveying only the current thinking as to what will probably be in the VCR program. Of course, there may be last-minute modifications and changes before it's actually issued. What's contemplated is that the sponsor can come in with a list of defects. There will be discussions with the Service. I would think there would probably be at least one conference, like a taxpayer conference, with definite interplay.

MR. CONAWAY: So there will be opportunity to discuss some of the issues.

MS. MARTICELLO: Right, but the issues will be raised by the plan sponsor. The Service will not otherwise investigate the situation.

MR. CONAWAY: Can the sponsor discuss methods of correction? I can imagine situations where there's going to be a range of options.

MS. MARTICELLO: The plan sponsor will be responsible for proposing correction, and we contemplate total correction. All participants would have to be where they would have been if there had been no problem. Now the plan sponsor's going to come in.

MR. CONAWAY: I have heard people express concern about getting into these discussions. It may be more likely that the plan will be audited in a subsequent year.

MS. MARTICELLO: No. If you come in to talk about it, the Service does not intend to use your coming in as a vehicle to precipitate an audit of your plan for issues other than those raised by the sponsor. At least that's certainly not the current intent. It doesn't mean you'll never be audited.

MR. CONAWAY: You mentioned the VCR program. The current thinking is that flagrant violations or defects wouldn't be covered. You also mentioned, for example, that exclusive benefit problems wouldn't be covered. Will there be guidance? I assume there will be guidance about what's flagrant and what's not, because I assume there are going to be differences of opinion where that line should be drawn.

MS. MARTICELLO: I think there definitely will be differences of opinion and it's going to be basically a facts-and-circumstances type of situation. Exclusive benefit makes it easier to determine what's a flagrant and repeated violation. Sometimes you know flagrant when you see it, but sometimes it's harder.

MR. CONAWAY: On the exclusive benefit issue, though, the concern I've heard is that oftentimes there will be a violation of an operational defect with respect to a specific requirement, but often the exclusive benefit rule functions as a catch all; a particular defect can often also be a violation of exclusive benefit. A sponsor goes in and gets relief with respect to a series of operational defects, but there's still this residual exclusive benefit violation which evidently hasn't been relieved. I think there's some concern about the interplay between the general exclusive benefit rule and then the more specific defect.

MS. MARTICELLO: I agree that that often happens. For example, in the Revenue Procedure 90-49 cases, money comes out improperly. It's an exclusive benefit violation. I think those issues can be addressed in closing agreements. I think it could be addressed under the VCR program; it's not fleshed out yet. It's something that has to be looked at.

MR. CONAWAY: The IRS still has to struggle then with those situations where a defect is both a violation of a particular rule and an exclusive benefit violation.

MS. MARTICELLO: Right.

MR. CONAWAY: There is a general council memorandum (GCM), which chief counsel prepared, discussing the exclusive benefit rule. It took a very expansive view of the scope of the exclusive benefit rule. Several plan sponsors are worried that this is the return of the exclusive benefit rule in a very expansive way, at least in this GCM, and that, obviously, could be important under the VCR program.