REPORT #887

TAX SECTION

New York State Bar Association

Priorities for Guidance With Respect to
Recent Legislation Affecting Employee Benefit Plans

Table of Contents

TAX SECTION

New York State Bar Association

October 15, 1996

Hon. Donald C. Lubick,
Acting Assistant Secretary (Tax Policy)
Department of Treasury
1500 Pennsylvania Avenue, N.W.
Washington, D.C. 20220

Hon. Margaret M. Richardson,
Commissioner
Internal Revenue Service
1111 Constitution Avenue, N.W.
Washington, D.C. 20224

Re: Priorities for Guidance on Recent Tax Legislation

Dear Secretary Lubick and
Commissioner Richardson:

Enclosed are comments that have been prepared in response to the request by the Treasury Department and the Internal Revenue Service for priorities regarding the issuance of guidance on recent law changes affecting employee benefit plans. Because of time constraints, the comments were prepared without review by the Tax Section Executive Committee and reflect only the views of its authors.

Very truly yours,

Richard L. Remhold
Chair

Enclosure
cc: J. Mark Iwry, Esq.
Mary E. Oppenheimer, Esq.

THE NEW YORK STATE BAR ASSOCIATION

TAX SECTION

Priorities for Guidance With Respect to Recent Legislation Affecting Employee Benefit Plans

The following comments[1] have been prepared in response to the request of the Treasury Department for priorities regarding the issuance of guidance on recent law changes affecting employee benefit plans. The following areas, which are not intended to be exhaustive, represent specific items on which the Committee feels that prompt clarification is needed.

Minimum Distributions. Section 1404(a) of the Small Business Job Protection Act of 1996 (the “Act”) amends Section 401(a)(9)(C) of The Internal Revenue Code of 1986, as amended (the “Code”), to eliminate the provisions which required that qualified plan distributions to active employees of the plan sponsor commence not later than April 1 of the year following the year in which the employees attained age 7014. The new provision does not, on its face, supersede the “anti-cutback” requirements of Code Section 411(d)(6). Accordingly, there is a strong argument that all plans (having previously required such distributions) would need to continue to offer distributions to active employees at age 7016, at least with respect to benefits accrued prior to 1997. As a result, existing plans need guidance as to whether mandatory distributions to active employees

[1] These comments were prepared by Stuart N Alperin and Kenneth C. Edgar, Jr., co-chairs of the Committee on Nonqualified Benefits, and Stephen T. Lindo and Loran T. Thompson, co¬chairs of the Committee on Qualified Plans (both committees being referred to herein collectively as the “Committee’). Helpful comments were received from Dianne Bennett.

(including those already in pay status) may be eliminated without violating Code Section 411(d)(6). While such a result might require a technical correction, it would appear that relief from the restrictions of Code Section 411(d)(6) would be appropriate to give effect to the intent of the Act and to avoid undue “grandfathering” complexity.

Section 401 (k) Nondiscrimination Testing. Under Code Section 401(k)(3)(A), as amended by Section 1433(c) of the Act, the actual deferral percentage (“ADP”) limit for highly compensated employees in a plan year is determined by reference to the ADP for nonhighly compensated employees (“NHCEs”) in the preceding plan year unless the employer makes an election (which is generally irrevocable) to base the limit on the ADP for the NHCE group in the current year. In the case of the first plan year of a plan (other than a successor plan), the ADP for the NHCE group for the preceding plan year is deemed to be 3% (or, at the employer’s election, the ADP for the NHCE group for the first plan year).

The Committee believes that guidance is needed as to the application of these rules where one plan (Plan A) is the successor to another plan (Plan B) as a result of a mid-year plan merger. Assuming that the two plans were not aggregated for nondiscrimination testing purposes before the merger, how do the respective ADPs for the two plans’ NHCEs for the preceding year affect the calculation of Plan A’s ADP ceiling for HCEs for the current year? For example, would the prior year’s ADP for NHCEs be calculated as if the plans had been merged as of the first day of the prior plan year? Would Plan B’s ADP for the prior year be disregarded? Is the answer affected by the relative size of the two plans? What if the plans had different plan years? Does it matter whether the sponsors of Plans A and B were members of the same controlled group before the merger?

<u>401(k) Plans for Tax-Exempt Organizations</u>. Act Section 1426 amends Code Section 401(k)(4)(B) to permit tax-exempt organizations and certain other organizations to establish qualified cash or deferred arrangements ("401(k) plans"). As noted by the Service in Announcement 95-48, 1995-23 I.R.B. 13, difficult issues arise for tax-exempt organizations in determining which entities must be aggregated under Code Sections 414(b) and (c), relating to the definition of employer. That Announcement solicited comments on this topic and provided that, until further guidance is issued, tax-exempt employers may apply a reasonable good faith interpretation of Code Sections 414(b) and (c) in determining which entities must be aggregated.

There has been substantial confusion among tax-exempt employers as to the manner in which Code nondiscrimination rules should apply in the case of affiliated organizations which work toward a common purpose or share a degree of common management. The existing test was articulated in Notice 89-23, 1989-1 C.B. 654 at paragraph V.B.2a. It requires 80% common control, through trustees, directors or other representatives of the contributing employer's governing body, or provision of 80% of the operating funds, coupled with a degree of common management or supervision.

In view of the limited resources and small number of non-volunteer employees of many tax-exempt organizations, the complexity of the 401(k) rules and discrimination testing requirements, and the fact that many 401 (k) plans will now be adopted that are largely or entirely self-funded by employees (most of whom are not highly compensated), the Committee believes that it would be desirable to have a clear articulation of the operative principles that will be applied in determining controlled group status. This would help to ensure that such plans are properly structured from the outset. The Committee also believes that some relaxation of the existing rules announced in Notice 89-23 may be appropriate in this instance. This would facilitate participation by employees of related organizations, reduce the number of plans and spread administrative costs across a broader base of participants.

Prohibited Transaction Excise Tax. Section 1453(a) of the Act amends Section 4975(a) of the Code to increase the initial-level excise tax on prohibited transactions from 5 percent to 10 percent. This amendment applies to prohibited transactions "occurring" after the date of enactment of the Act.

The Committee believes it is necessary for the Service to address the issue of whether the increased rate of tax will apply to prohibited transactions which initially occurred prior to the date of enactment, but which may be viewed as "continuing" in nature (e.g., a prohibited extension of credit which originated prior to enactment but which continues subsequent to the date of enactment) or to other pre-enactment prohibited transactions which were not corrected prior to the date of enactment. The Committee believes that most prohibited transactions are event specific, i.e., they are based on a single event, and so long as there is no additional prohibited conduct which takes place after the original transaction, other than the failure to correct, the date of occurrence should remain static. Accordingly, the Committee believes that the transactions described in the second preceding sentence should normally be viewed as having "occurred" prior to the date of enactment and that, therefore, the increased rate of tax should not apply to such transactions. The Committee notes that such a finding would be consistent with the language of Code Section 4975(f)(2), which defines the taxable period with respect to a prohibited transaction as beginning on the date on which a prohibited transaction “occurs” and ending on the earliest of various dates specified in such section.

Section 4980A Excise Tax on Excess Distributions. Due to the impending effective date of this section, immediate guidance is needed as to its application. In particular, questions have arisen with respect to interrelationship of the grandfather rules and the new provision, especially where the amount distributed exceeds the non-grandfathered amount. Some taxpayers, particularly those not in good health, may want to take distributions as early in 1997 as possible, and therefore guidance is needed in the immediate future.