CHAPTER 8

Plan Distributions: Taxation, Withholding and Other Requirements

KEVIN P. O'BRIEN

Partner, Ivins, Phillips & Barker. Mr. O'Brien received his B.A., J.D. and LL.M (Tax) degrees from Georgetown University. He specializes in employee benefits and ERISA matters and is a member of the ABA Tax Section, and serves on the Employee Benefits Committee. Mr. O'Brien has lectured at numerous clinics on the subject of employee benefits and taxation, including the NYU Conference on Employee Benefits and Executive Compensation.

SYNOPSIS

§ 8.01 INTRODUCTION

The taxation of distributions remains complicated despite repeated calls for simplification. The Unemployment Compensation Act of 1992 (UCA), which was intended to liberalize and simplify the rules governing rollovers from qualified plans, has posed numerous interpretative difficulties and caused further uncertainty. This article discusses the changes in the rollover and withholding rules under the UCA, focusing on the key issues raised by the temporary and proposed regulations. Although proposed technical corrections to the UCA were not enacted in 1992, this article also discusses those proposed changes. Finally, the article reviews other recent developments in the taxation of distributions from qualified plans, and also discusses whether defined benefit plan payments can be used to fund retiree health benefits on a pre-tax basis.

§ 8.02 THE UNEMPLOYMENT COMPENSATION ACT (UCA)

[1] In General

The Unemployment Compensation Act (UCA), which was effective for plan distributions on and after January 1, 1993, expanded the types of plan distributions eligible for rollover. The UCA also added rules requiring all qualified plans and Section 403(b) annuities to permit the "direct rollover" of "eligible rollover distributions". "Eligible rollover distributions" that are not "directly rolled-over" are subject to a 20 percent withholding tax. Traditional rollovers (where the participant receives a distribution and rolls the distribution over within 60 days of receipt) are still allowed, although much less attractive because of the 20 percent withholding tax. Plan distributions that are not "eligible rollover distributions" but otherwise qualify as "designated distributions" under Code section 3405 remain subject to the voluntary, election-out, withholding of Code section 3405. It is possible for one part of a distribution to be subject to the new 20 percent withholding tax, with the remainder subject to the old, election-out withholding, so that different withholding rates apply to the same distribution.

Soon after the UCA was passed, it became apparent that "simplification" does not come easy and that the law suffered from numerous technical flaws. Technical corrections were included in H.R. 11, the 1992 tax bill that was vetoed by President Bush in November 1992.[1] The IRS addressed a number of the problems when it published temporary and proposed regulations on October 22, 1992,[2] but employers have been left to struggle with ambiguities in the law and the need for technical correction remains. The IRS also has published a series of notices and announcements dealing with the new withholding and rollover rules and has published a model "safe harbor" notice under Code section 402(f) describing the new rules.[3]

---

[1] Section 6102(j) of H.R. 11, known as the "Revenue Act of 1992"; H. Rept. 102–1034, 102d Cong., 2d Sess (1992). As of June 1, 1993, technical corrections to the UCA have not been introduced in the 103rd Congress.

[2] 57 Federal Register 48113, 48194 (October 22, 1993).

[3] IRS Notice 92–48, 1992–45 IRB 25 sets forth a safe harbor notice that plans may distribute to satisfy the Code section 402(f) notice requirement; IRS Announcement 92–169, 1992–49 IRB 77, provided information describing the new

§ 8.03 KEY ISSUES UNDER UCA AND THE IRS TEMPORARY AND PROPOSED REGULATIONS

[1] Eligible Rollover Distributions

Under the UCA, an "eligible rollover distribution" is any distribution from a qualified plan unless it is (1) one of a series of substantially equal periodic payments made (a) for a specified period of ten or more years or, (b) not less frequently than annually for the life or the life expectancy of the employee (or joint lives or life expectancy of the employee and the employee's designated beneficiary) or, (2) a required distribution under Code section 401(a)(9).[4]

[2] Substantially Equal Periodic Payments

Whether a series of payments are "substantially equal" and meet the term limitations for "eligible rollover" treatment is determined when payments begin, without regard to contingencies or modifications that have not yet occurred.[5] In general, the principles of Code section 72(t)(2)(A)(iv)[6] apply, and an annual payment method comes within Code section 72(t)(2)(A)(iv) if it satisfies the "substantially equal" rule of code section 401(a)(9). These principles have not been easy to apply and leave many basic questions answered.[7]

---

distribution codes to be used on the 1993 Form 1099-R; IRS Announcement 93–20, 1993–6 IRB 65 supplements the 1953 Form 1099-R instructions for reporting direct rollovers; IRS Notice 93–3, 1993–3 IRB 11, deals with the application of the UCA requirements to plan loans; Rev. Proc. 93–12, 1993–3 IRB 14 contains model plan language which can be used by plans to satisfy the "direct rollover" requirement of Code section 401(a)(31); IRS Notice 93–26, 1993–18 IRB 11, provided additional guidance on the 90/30 day rule and distributions from annuity contracts.

[4] The temporary and proposed regulations also list the following exclusions from the definition of "eligible rollover distribution": elective deferrals under Code section 401(k) that are returned as a result of the Code section 415 limitations; corrective distributions of excess contributions, excess deferrals and excess aggregate contributions under Code sections 401(k) and (m); loans treated as distributions under section 72(p); loans in default that are deemed distributions; dividends paid on employer stock as described in section 404(k) and the cost of life insurance coverage (the "P.S. 58" costs). Temp. Treas. Reg. § 1.402(c)–2T, Q&A 4.

[5] Temp Treas. Reg. § 1.402(c)–2T, Q&A 5(a).

[6] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 5(a).

[7] IRS Notice 89–25, 1989–1 C.B. 662, Q&A 12.

[a] *Disability Pensions*

It is unclear how disability pensions are treated under this rule. Can the employer assume that the participant will remain disabled for more than ten years so that the distribution can be treated as ineligible for rollover treatment? Presumably, since future contingencies or modifications are ignored, the employer may ignore the possibility that the participant will recover from the disability within 10 years. Also, if the participant continues to accrue normal retirement benefits while disabled, such that the normal retirement benefit may be larger than the disability benefit, the employer should be able to ignore the possibility that the disabled participant will survive until the normal retirement date and receive a larger pension.

[b] *Fixed Dollar Installments*

Many defined contribution plans allow a participant to receive fixed dollar installments (e.g., $500 per month) until the account is paid in full. Apparently, the plan administrator may assume a future rate of return ranging anywhere from a zero rate to a "reasonable rate" in determining whether payments will be made over ten years.[8] Since the plan administrator's earning assumption affects the rollover status of a distribution, it is surprising that the regulations do not set forth a more exact rule. To avoid conflicts with plan participants concerning their "direct rollover" rights, it probably makes sense to spell out the earnings assumptions in the plan's direct rollover provision under Code section 401(a)(31). For plans, such as money purchase plans, that are subject to the "definitely determinable" benefit requirements, the interest rate may have to be spelled out to avoid problems of impermissable discretion.[9]

---

[8] In private rulings involving Notice 89–25, *supra;* the IRS has blessed the use of interest rates ranging from 5 percent to 10.6 percent. Private letter rulings 8921098 (Undated); 9040044 (July 10, 1990); 9047043 (August 28, 1990); 9047076 (August 30, 1990); 9050046 (September 18, 1990).

[9] The preamble to the Code section 411(d)(c) regulations noted as follows:

> The final regulations continue to provide that a pension plan does not satisfy the definitely determinable requirement of section 401(a), including section 401(a)(25), if any section 411(d)(6) protected benefit is conditioned on employer discretion. (The term "discretion" refers to both consent and other forms of discretion.) Of course, the definitely determinable requirement is not limited to section 411(d)(6) protected benefits under pension plans.

[c] *Changes in Payment Amount*

As noted, in determining whether payments constitute a series of substantially equal periodic payments, contingencies that have not occurred are not taken into account. If the method of payment changes, however, a new determination must be made of whether the remaining payments are a series of substantially equal payments and the payments made before the change are ignored.[10] This rule offers planning possibilities for payments commencing before 1993. Generally, all pre-1992 payments are taken into account when determining whether the post-1992 payments qualify as substantially equal periodic payments that can be rolled over. Thus, if a 15-year installment payment commenced in 1980, the remaining payments would not be an "eligible rollover distribution" even though the post-1992 payments are scheduled to last less than ten years. If the plan permits payout changes, however, a participant could make remaining payments eligible for rollover treatment by making a change in the payment amount.

Defined contribution plans with fixed dollar installment options (i.e., $500 per month) sometimes allow the participant to take "extraordinary" payments, while leaving the subsequent monthly payments the same as the original monthly amounts. The regulation addresses the situation where all future payments are changed (such as where the participant changes from $100 per month to $200 per month), but does not clearly deal with the effect of the extraordinary payment on the remaining payments.[11] Presumably, both situations are treated the same, and a new determination of rollover status is made after the extraordinary payment.

[d] *Spousal Benefits Under Term Certain Annuities*

Surviving spouses, but not other death beneficiaries, are eligible to rollover any "eligible rollover distribution" to an "individual

---

53 Fed. Reg. 26052 (July 11, 1988).

The right to make rollover contributions and transfers to and from the plan is a "right or feature" under Treas. Reg. § 1.401(a)(4)–4(e)(3)(iii)(I).

10 Temp Treas. Reg. § 1.402(c)–2T, Q&A 5(c).

11 Temp. Treas. Reg. § 1.402(c)–2T, Q&A 5(c). The extraordinary payment itself would be a payment that is independent of the rest of the payments and would be separately tested for "eligible rollover" status under Temp. Treas. Reg. § 1.402(c)–2T, Q&A 6. See the discussion under § 8.03[2][e].

retirement plan."[12] The regulation is unclear when the determination of "eligible rollover status" is made with respect to the surviving spouse. If the employee was receiving 15-year installment payments (i.e., the distribution was not an "eligible rollover distribution") and the participant dies at any time after receiving five years of installments, is the remaining distribution to the spouse an "eligible rollover" distribution? If the status of the distribution is determined at the time the distribution commenced to the employee, the spouse could not rollover the remaining amounts unless a change is made in the amount of the remaining payments. There has been some indication from the Service that the character of the distribution is determined when the benefit commences and that the death of the participant should not affect the treatment of the payment as to the beneficiary.[13]

[e] *Social Security Supplements and Level Income Options*

Social security supplements are ignored when determining whether a series of payments are substantially equal; however, a social security supplement is taken into account if otherwise unequal payments would become "substantially equal" by taking the social security payments into account.[14] The temporary and proposed regulations fail to address level income options, which are similar in concept to social security supplements. Under a level income option, the participant receives an annuity that provides larger annuity payments before social security benefits begin and lower annuity payments thereafter.

---

[12] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 10. Surviving spouses can rollover to an individual retirement account or individual retirement annuity, but not to another qualified plan. It is not entirely clear under the temporary and proposed regulations how the $5,000 lump sum death benefit of Code section 101(b) applies. The Code section 3405 regulations provide that this amount is not part of the "designated distribution" because it is reasonable to believe that the death benefit is excludable from the survivor's income. Treas. Reg. § 35.3405–1, Q&A 28. Some commentators have asked that these amounts be treated like "net unrealized appreciation" and be made eligible for rollover.

[13] 19 BNA Pension Report No. 47, p. 2118 (November 30, 1992) (remarks of Marjorie Hoffman).

[14] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 5(b). Section 6102(j)(i) of the technical corrections in H.R. 11 would have codified the first part of this answer, but not the second part. Specifically, it would have modified the definition of "eligible rollover definition" in Code section 402(e)(4) to provide that, "any social security supplemental payment described in the last sentence of section 411(a)(9) shall be disregarded in determining whether payments are substantially equal."

[f] *Independent Payments*

Payments that are independent of a series of substantially equal payments may qualify as "eligible rollover distributions" if they are substantially larger or smaller than other payments. It doesn't matter if the independent payment is made before, after, or with a payment in a series.[15] If "make-up" payments are made to a participant because of some administrative mistake, is the make-up payment treated as an "independent payment"? Under the pre-UCA withholding regulations, a one-time make-up payment was treated as part of a series of periodic payments.[16]

[3] Payments Satisfying Code section 401(a)(9)

[a] *In General*

A distribution is not an "eligible rollover distribution" to the extent that it is required under Code section 401(a)(9). All amounts distributed in a year, up to the Code section 401(a)(9) minimum, are ineligible for rollover, but all amounts in excess of the Section 401(a)(9) minimum distribution are eligible for rollover. Thus, if a participant is required to receive $1,000 a year to satisfy Code section 401(a)(9) and the participant receives four quarterly distributions of $400 each, then the first two distributions and $200 of the third distribution are not "eligible rollover distributions", but the remaining $600 could be if it otherwise meets the requirements.[17] This is a case where multiple withholding tax rates could apply to the distributions. In the example above, the first $1,000 distributed is subject to withholding under the old rules of Code section 3405 (unless the participant elects out of withholding) and the remaining $600 would be subject to 20 percent if it otherwise qualifies as an "eligible rollover" distribution. Any Code section 401(a)(9) minimum distribution for a year that is not distributed until the next year is added to the next year's minimum.

Calculating the Code section 401(a)(9) minimum amount is very burdensome for plans. Plans paying lump sums when a participant attains the Code section 401(a)(9) "required beginning date" are

[15] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 6.

[16] See Treas. Reg. § 35.3405, Q&A B-8.

[17] Temp. Treas. Reg. § 1.402(c)–2T, Q&As 3 and 7; IRS Notice 93–3, *supra,* Section IV.

not otherwise bothered by the complicated Code section 401(a)(9) requirements. Accordingly, this has been among the more highly criticized aspects of the temporary and proposed regulation. Most commentators have asked that plan administrators be able to presume that any distribution during or after the year in which the employee attains age 70–1/2 is a required distribution under Code section 401(a)(9).

[b] *Relief from Code section 401(a)(9) Problem*

The IRS has offered two limited concessions addressing the Code section 401(a)(9) problem. First, the temporary and proposed regulations allow the plan administrator to assume that an employee has no designated beneficiary for distributions before the participant's death.[18] This means that the administrator need know only the participant's birthday when calculating the Code section 401(a)(9) minimum distribution. Since the short-cut method may reduce the amount the participant can directly rollover, the regulation clarifies that the participant can use a traditional rollover to rollover the difference between the minimum calculated under the simplified method and the minimum determined under the "normal" Code section 401(a)(9) rules. The short-cut method only applies for distributions to plan participants and does not apply to post-death distributions to a surviving spouse. Since use of the short-cut method may reduce the amount a participant can directly rollover, the election not to use the short-cut method should be spelled out in the plan document.

The Service's second accommodation on Code section 401(a)(9) appears in Notice 93–3 and is limited to defined benefit plans. Notice 93–3 provides that all annuity payments payable from a defined benefit plan made on or after January 1 of the year in which the participant attains age 70–1/2 are treated as Section 401(a)(9) required distributions and are not "eligible rollover distributions."[19] Unlike the simplified method for calculating minimum distributions, this is not an elective rule. Plans that use the IRS's model Code section 402(f) notice or that have adopted the IRS model Code section 401(a)(31) amendment should note that these models were published before IRS Notice 93–3 and do not reflect Notice 93–3.

[18] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 7(b).

[19] 1993–3 IRB 11.

IRS Notice 93–3 also clarified that any distribution from a defined benefit or defined contribution plan before January 1 of the year in which the employee attains (or would have attained) age 70–1/2 are not treated as required distributions under Section 401(a)(9) and may qualify as an "eligible rollover distribution." This clarification was added because a literal reading of the Code section 401(a)(9) regulations suggested that these annuity payments were treated as Code section 401(a)(9) payments.

The proposed technical corrections offered limited help on the Code section 401(a)(9) problem. Under the proposed technical corrections, 20 percent withholding could be applied to the total distribution if Code section 401(a)(9) required distribution is "de minimus" (10 percent) when compared to the total amount distributed. This would help plans paying lump sums on the "required beginning date", but no others. Also, the proposed technical correction affected only the withholding tax rate and did not allow the Code section 401(a)(9) minimum contribution to be rolled over.

[4] Other Specific Issues

[a] *Hardship Distributions*

Many have questioned the applicability of the 20 percent withholding and direct rollover rules to hardship distributions under Code section 401(k) plans. Would a direct rollover of a hardship distribution indicate a lack of financial necessity?

The temporary and proposed regulations do not spell out any special rules for hardship distributions.[20] The proposed technical corrections would have amended the definition of "eligible rollover distribution" in Code section 402(c)(4) by excluding hardship distributions.[21] The provision would have been limited to the hardship distribution of elective contributions under a Section 401(k) plan and would not have covered earnings on after-tax contributions or matching contributions.

Certainly, with items such as tuition costs, it is possible to withdraw up to 12 months of costs, so a direct rollover is not incompatible with such a hardship request. In any event, unless the Service clarifies the issue, it is difficult to imagine the Service

[20] Section 6102(j)(3)(E) of H.R. 11.

[21] Section 6102(j)(1)(C) of H.R. 11.

disqualifying a section 401(k) plan because it follows the requirements of Code section 401(a)(31).

[b] *Plan Loans*

The temporary and proposed regulations included two confusing provisions dealing with plan loans. First, the regulations provided that both a "deemed distribution" resulting from a loan treated as a distribution under Code section 72(p), as well as a loan in default, are not "eligible rollover distributions."[22] In contrast, however, the regulations provided that an unpaid loan balance that is offset against a participant's account balance at termination of employment is an "eligible rollover distribution."[23] The temporary regulations caused considerable stir since loan defaults and loan offsets are difficult to distinguish. Also, if a loan is offset before a termination of employment, there is no cash distribution to withhold from.[24]

The IRS clarified the proper treatment of loans under the new withholding and rollover rules in IRS Notice 93–3.[25] This notice clarifies that an offset (and hence an "eligible rollover distribution") occurs whenever the participant's accrued benefit is reduced to repay the loans. It does not matter whether or not the offset occurs after the participant has terminated employment. A loan will be viewed as "offset" even if the offset occurs because the plan document treats the loan as accelerated or in default upon the employee's termination of employment. Where there is a loan offset, the 20 percent withholding applies. IRS Notice 93–3 also clarifies that withholding is required only on an amount up to the amount of cash actually distributed. Further, if a loan becomes taxable because of a failure to meet Code section 72(p), but the offset to the account is delayed until a later date, Notice 93–3 clarifies that the amount of the prior deemed distribution under Code section 72(p) is treated as an employee contribution for basis

---

[22] Temp. Treas. Reg. § 1.402(c)–2T Q&A 4(c) and (d).

[23] Temp. Treas. Reg. § 1.402(c)–2T Q&A 8.

[24] The exception from "eligible rollover distributions" for "deemed distributions" of loans is not in the statute. The 1992 technical corrections only would have excluded deemed distributions "by reason of a default of a loan described in section 72(p)(2)" or other "similar distributions" specified in IRS regulations.

[25] 1993–3 IRB 11.

purposes; accordingly, this amount does not qualify as an "eligible rollover distribution" when there is a subsequent distribution.[26]

IRS Notice 93–3 also states that a plan is permitted, but not required, to provide that a plan loan offset cannot be directly rolled over. The IRS Model Plan provision[27] preceded the publication of Notice 93–3 and does not reflect the Notice. For practical purposes, all plans should be drafted to disallow the "direct rollover" of loan offset amounts. If the plan does not so provide, a participant might argue that they are entitled to a "direct rollover" of the offset amount (and not just the plan note) even though they already have the cash from the original loan.

"Deemed" distributions resulting from loans that violate Code section 72(p) at the time the original loan is made appear to be subject to voluntary withholding under the old rules of Code section 3405; it is not clear whether loans that become taxable after they are originally made but before foreclosure are subject to the voluntary withholding rules.[28]

In addition to its guidance on the direct rollover rules, IRS Notice 93–3 notes that a deemed distribution occurs when a loan is in default because of a missed or untimely payment. This is the first formal statement from the IRS on this issue. Many plans allow some grace period on missed payments without treating the loan as in default. Some practitioners argue that the Code section 72(p)(2) requirements apply solely to the terms of the loan and argue that there is nothing in Code section 72(p)(2) requiring taxation when the terms of the loan are not satisfied. Indeed, the legislative history of Code section 72(p)(2) suggests that missed loan payments do not cause the loan to become taxable right away.[29]

[c] *Distributions from Previously Distributed Annuity Contracts*

Many plans distribute annuity contracts to plan participants. These may involve individual annuity contracts, such as when a

---

26 Notice 93–3 1993–3 IRB Example 6.

27 Rev. Proc. 93–12, 1993–3 IRB 14.

28 Treas. Reg. § 35.3405, Q&A F4.

29 The TEFRA Conference Report, at page 619, stated:

In addition, if payments under a loan with a repayment period of less than five years are not in fact made, so that an amount remains payable at the end of five years, the amount remaining payable is treated as if distributed at the end of the five-year period.

participant in a defined contribution plan elects an annuity payment, or an annuity "certificate" representing an interest in a group annuity contract, such as is required when an employer closes out a defined benefit plan under Title IV of ERISA. There was considerable uncertainty whether the 20 percent withholding and direct rollover rules apply to distributions from the annuity contracts. To some extent, the annuity contract is treated as if it is part of the ongoing plan. For example, the joint and survivor annuity requirements, the Code section 411(a)(11) payout restrictions, the anti-cut back rules of Code section 411(d)(6), and the Code section 401(a)(9) minimum payment requirements apply to the annuity contract.[30] For lump sum purposes, however, the treatment of lump sums payable under annuity contracts has not been very clear. The IRS has held that the distribution of an annuity contract is the plan distribution and that full lump sum tax treatment is available only if the annuity contract is cashed-in within the year the contract is distributed, at least where the annuity contract could be cashed-in by the distributee and the plan trustee was not the contractholder.[31] Although the Internal Revenue Service has ruled that lump sum tax treatment is available when a trustee owns a group annuity contract, whether or not the participant has an unlimited right to cash-in the contract, the Service also has held that lump-sum tax treatment is not available in such case.[32]

IRS Notice 93–26[33] clarifies that amounts paid under a distributed annuity contract are "eligible rollover distributions" if they otherwise met the term limitations. Accordingly, the payor must provide a written explanation to the participant that satisfies Code section 402(f), ensure that distributions of "eligible rollover distributions" are provided a direct rollover option as required under Code section 401(a)(31), and withhold tax under Code section

---

30 Treas. Reg. § 1.401(a)–20, Q&A 2; Treas. Reg. § 1.411(a)–11(e)(1); Treas. Reg. § 1.411(d)–4 Q&A-2(a)(3); Prop. Treas. Reg. § 1.401(a)(9)–1, Q&A F-4.

31 Compare private letter ruling 8012047 (December 27, 1979) (lump sum tax treatment where trustee owned the contract and participants could cash-in contract at any time); Private letter ruling 8305147 (November 8, 1982) (lump sum tax treatment where trustee owned the contract and participant could receive lump sum only after retirement); *with* private letter ruling 8035054 (June 5, 1980) (lump sum treatment not available where trustee owned the contract and recipient could cash-in the contract).

32 Rev. Rul. 81–107, 1981–1 C.B. 201; Rev. Rul. 68–287, 1968–1 C.B. 174.

33 1993–18 IRB 11 (May 3, 1993).

3405(c). The effective date of this clarification is January 1, 1994, although taxpayers and payors may rely on the clarification before that date. IRS Notice 93–26 does not discuss the lump sum tax treatment of distributions from annuity contracts, and there have been informal indications that it does not signal any change in the Service's position.

[5] Notice and Consent Requirements

The statute requires that plans must provide "eligible rollover distribution" recipients a Code section 402(f) notice within a "reasonable period of time" before the distribution. The temporary and proposed regulation required that this notification must be "in writing" and must be given at least 30 days, and not more than 90 days, before the distributee's "annuity starting date."[34]

The 90/30-day rule applies to plans subject to the consent requirements of Code section 411(a)(11). Where consent is unnecessary under Code section 411(a)(11) (e.g., under the $3,500 cashout rule), the recipient may elect to waive the 30-day rule. It also appears that a spouse (or former spouse under a QDRO) may be able to elect an immediate direct rollover without waiting the 30 days.[35]

Code section 402(f) does not apply to distributions from section 403(b) annuities, but the temporary regulations require the payor of a section 403(b) annuity to provide an explanation of the direct rollover provisions. The explanation must be provided within a reasonable time before making the distribution, but the regulations do not require that it be provided within the 90/30-day period.

The 90/30 day rule has been among the most unpopular provisions in the temporary and proposed regulations.[36] Most commentators asked that a plan participant be able to waive the 30-day requirement so that the plan does not have to delay payment to a participant. Others requested that participants be allowed to waive

34 Treas. Reg. § 1.402(c)–2T, Q&A 12.

35 Temp. Treas. Reg. § 1.402(c)–2T, Q&A 13.

36 The preamble to the regulation specifically asked for comments on the 90/30-day rule, not only in connection with the withholding rules, but also under the joint and survivor annuity rules.

the 30-day rule only in certain cases, such as hardship distributions.[37]

The IRS finally offered relief from the 90/30 day rule in IRS Notice 93–26.[38] The Notice modifies the "reasonable period of time" rule of the proposed and temporary regulations by allowing a participant to waive the 30-day period. In order to waive the 30-day requirement, participants must be afforded the opportunity to take at least 30 days after the Code section 402(f) notice is provided to make a rollover decision, and the plan administrator must inform participants of the right to use the full 30 days to make the direct rollover decision. Any reasonable method may be used to inform participants about the 30-day election period. For example, Notice 93–26 states that the information could be provided in the section 402(f) notice or stated in a separate document, such as the election form.[39]

Notice 93–26 also clarifies the definition of the "annuity starting date" for purposes of applying the joint and survivor and consent requirements of Code section 401(a)(11), 411(a)(11) and 417 to non-periodic payments that are not subject to the joint and survivor annuity requirements of Code section 401(a)(11). The "annuity starting date" definition in the Section 401(a)(11) regulations had been a source of confusion for defined contribution plan sponsors. For example, if a plan made a payment from a profit sharing plan on July 24 based on a June 30 valuation and the participant had to make the election by June 20 to receive the July distribution, which date was the "annuity starting date"?[40] Notice 93–26 clarifies that the date of distribution (i.e., July 24 in the previous example) is the "annuity starting date" for purposes of the withholding rules.

---

37 A number of commentators noted that the 30/90-day rule conflicts with the seven-day redemption rule for mutual funds under section 22(e) of the Investment Company Act of 1940.

38 1993–18 IRB 11 (May 3, 1993).

39 Notice 93–26 also provides that a plan will not fail to satisfy the Code section 411(a)(11) consent requirement merely because a distribution is made less than 30 days after notice is provided to a participant. The Notice does not affect the 90/30 day rule that applies for purposes of the Code section 417 joint and survivor benefit rules. *See* Treas. Reg. § 1.417(e)–1(b)(3).

40 Under the Code section 401(a)(20) regulations the "annuity starting date" is the "first day of the first period for which an amount is paid as an annuity or otherwise." Treas. Reg. § 1.401(a)–20(b)(2).

The regulations also pose a problem for plan sponsors that have adopted voice response or computer response systems. The temporary and proposed regulations require that the Code section 402(f) notice be "in writing" and the Code section 411(a)(11) regulations require the "written" consent of a plan participant.[41] The regulations do not require that a participant's direct rollover election must be in writing, and the IRS model amendment merely refers to a participant's election "at the time and in the manner prescribed by the plan administrator."[42] Notice 93–26 does not offer any relief for computer and voice response systems, but it notes that the IRS will "continue to consider what modifications to the regulations, if any, are appropriate" in the context of these new technologies, and invites further comments.

Despite Notice 93–26, administrative difficulties remain with the Code section 402(f) notice requirement. The notice may not be provided more than 90 days before the "annuity starting date," which means that many employers will have to continue the expensive practice of providing the notice to all participants each quarter. Although the Section 411(a)(11) regulations seem to allow for bulletin board posting of the Code section 402(f) notice,[43] a continuous posting could be viewed as violating the 90-day requirement. The frequency of providing the rollover notice also is a problem. With a series of periodic payments, the Code section 402(f) notice requirement must be satisfied before the first payment in the series and at least annually for as long as the payments continue.[44] The proposed technical corrections would have provided that the Code section 402(f) notice need be provided only before the first payment of the series of periodic payments.[45]

---

41 Treas. Reg. § 1.402(c)–2T, Q&A 12; Treas. Reg. § 1.411(a)–11(c)(2)(ii) and (c)(3).

42 Rev. Proc. 93–12, 1993–3 IRB 14; also, Treas. Reg. § 1.401(a)(31)–1T, Q&A 6 states that "the plan administrator may prescribe any procedure for a distributee to elect a direct rollover under section 401(a)(31)."

43 Treas. Reg. § 1.411(a)–11(c)(3)(ii).

44 Temp. Treas. Reg. § 1.402(c)–2T, Q & A 14.

45 Section 6102(j)(1)(G) of H.R. 11.

§ 8.04 DIRECT ROLLOVERS UNDER CODE SECTION 401(a)(31)

[1] Plan Amendment for Direct Rollover

Under Code section 401(a)(31), qualified plans must afford participants the opportunity to rollover their eligible distributions directly from the qualified plan to an eligible retirement plan designated by the recipient. The required direct rollover plan amendment does not have to be made until the first plan year beginning on or after January 1, 1994, provided the amendment applies retroactively to January 1, 1993 and the plan operates in accordance with the new rules. All terminating plans, however, must be amended at the time of termination to comply with Code section 401(a)(31).

The IRS has published a model plan provision that may be used to satisfy the requirements of Code section 401(a)(31). The model provision is very simple and does not reflect a number of options that are available to employers. The Service apparently believes that many of these provisions may be adopted by the employer administratively, but a well drafted plan will want to reflect many of these elections:

(1) The plan may provide that loan offsets can be rolled over directly.[46]

(2) The plan may limit direct rollovers to one eligible retirement plan designated by the participant.[47]

(3) The plan may provide that, if a participant elects to have part of a plan benefit directly rolled over, the direct rollover must be at least $500.[48]

(4) The plan may provide that direct rollovers are not allowed if distributions from the year are reasonably expected to total less than $200, or a lower minimum specified by the plan administrator.[49]

---

[46] IRS Notice 93-3, *supra.*

[47] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 10.

[48] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 9.

[49] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 11. Section 6102(j)(2)(A)(iii) of the proposed technical corrections in H.R. 11 would have amended Code section 401(a)(31) to provide that where a participant receiving a series of eligible rollover distributions has elected direct rollover treatment, the election would be effective for each distribution in the series until revoked.

(5) A plan may provide that an election whether or not to rollover directly applies to all subsequent payments in a series.[50]

(6) The plan may designate a default rollover vehicle.[51]

(7) The plan may prescribe procedures for electing a direct rollover, including a statement from the designated recipient plan that the recipient plan is intended to be an IRA, individual retirement annuity, qualified plan or Code section 403(a) annuity and that it will accept the rollover.[52]

(8) The plan may adopt a short-cut method for computing the amount required to be distributed under Code section 401(a)(9) whereby it is assumed that there is no designated beneficiary under Code section 401(a)(9).[53] For annuity payouts from a defined benefit plan, the plan should provide that all payments after the participant attains age 70–1/2 are deemed to be required payments under Code section 401(a)(9), and accordingly not subject to direct rollover.[54]

(9) The plan may want to provide that a direct rollover may be made only in cash.[55]

The IRS model amendment provides that a direct rollover may be made to any qualified plan that accepts the rollover. Code section 401(a)(31)(D), however, provides that only "defined contribution plans" are qualified to accept direct rollovers. The technical

[50] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 12.

[51] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 7. If the employer designates a specific IRA as a direct rollover default vehicle, will the employer be viewed as "endorsing" the TRA so as to make the IRA a "pension plan" for ERISA purposes? A number of DOL opinion letters suggest that "pension plan" status can be avoided in this situation. DOL Opinion 82–31A (July 14, 1982) and DOL Opinion 83–10A (February 9, 1983).

[52] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 6. The Conference Report to the technical corrections clarified that a distributing plan and its administrator would not be subject to penalties or liability because of reasonable reliance on information provided by a benefit recipient regarding the eligible retirement plan to which a direct rollover is to be made. Reliance would be deemed reasonable to the extent information is certified to be accurate by the recipient plan. The temporary regulations are more lenient and provide that an employer may reasonably rely on a representation from the participant that the recipient plan is an IRS or qualified plan. Temp. Treas. Reg. § 31.3405(c)–1T, Q&A 7.

[53] Temp. Treas. Reg. § 1.402(c)–2T, Q&A 7.

[54] IRS Notice 93–3, Part IV.

[55] Code section 408(e)(5).

corrections would have amended the statute to provide that defined benefit plans may also accept direct rollovers.[56] A plan will not violate any qualification requirement by offering a direct rollover to a defined benefit plan. Until the law is changed, the IRS may view such a transfer as a distribution and rollover subject to the 20 percent withholding.

[2] Whether to Accept Rollovers

The temporary regulations make it clear that qualified plans and Code section 403(b) annuities are not required to accept rollovers.[57] A plan accepting rollovers should have procedures to ensure that rollovers come from qualified plans. There is no relief for acting on a reasonable, good faith belief that a sending plan was qualified. The Conference Report to the unenacted technical corrections provided that a plan accepting a direct rollover would not be disqualified, and the administrator not subject to penalties or liability, because of reasonable reliance on information provided by an individual or the administrator of the distributing plan that distribution was an eligible rollover distribution.[58] Reliance would be reasonable, according to the Report, if the distributing plan certifies that it is intended to be, and is administered as if it were, a qualified plan.

[3] Timing of Rollovers

Under pre-UCA law, a rollover was required to be made within 60 days after a distribution was received. A recipient was viewed as having received a distribution on the day the recipient received the last payment in a series of payments that constituted a lump sum distribution or a partial distribution.[59] Although the temporary UCA regulations do not deal with the issue, there have been informal indications that the 60-day period will be measured separately for each payment.[60]

---

[56] Section 6102(j)(2)(D) of H.R. 11.

[57] Temp. Treas. Reg. § 1.401(a)(31)–1T, Q&A 13.

[58] H. Rpt. 102–1034, 102d Cong., 2d Sess. 1092.

[59] Private letter rulings 8201075 (October 9, 1981) and 7802035 (October 19, 1977).

[60] *See* Tax Notes, March 29, 1993, P. 1757 (remarks of Richard J. Wickersham at the 1993 IRS/American Society of Pension Actuaries Midwest Region Employee Benefits Conference).

There is no 60-day period for "direct rollovers." The Conference Report to the unenacted technical corrections would have clarified "that a direct rollover is deemed to satisfy the requirement that a rollover be completed within 60 days of distribution, whether or not distributed assets are actually deposited in an eligible retirement plan within such period."[61]

[4] Who May Rollover

A plan participant may directly roll over a distribution to any eligible retirement plan.[62] The same is true for a former spouse who is an alternate payee under a qualified domestic relations order (QDRO).[63] A surviving spouse of a deceased participant may directly rollover a distribution to an IRA, but not to any other eligible retirement plan.[64] Distributions to QDRO alternate payees other than former spouses are not "eligible rollover distributions" and may not be rolled over by the alternate payee.[65] Oddly, the unenacted technical corrections would have narrowed the rollover rules for QDRO beneficiaries by providing that no distribution to a QDRO beneficiary, whether or not a former spouse, is an "eligible rollover distribution."[66]

§ 8.05 WITHHOLDING ON PROPERTY DISTRIBUTIONS

[1] In General

If a recipient of an eligible rollover distribution does not elect to directly rollover the distribution to an eligible retirement plan, the part of the distribution not directly rolled over is subject to a 20 percent withholding tax.

[2] Property Distributions

Generally, if property other than cash is distributed, the plan administrator must satisfy the withholding obligation by selling the

---

61 H. Rpt. 102–1034, 102d Cong. 2d Sess 1092.

62 Temp. Treas. Reg. § 1.402(c)–2T, Q&A10(a).

63 Ibid.

64 Ibid.

65 Temp Treas. Reg. § 1.402(c)–2T, Q&A10(b). Under IRS Notice 89–25, however, it is possible that the participant can rollover this distribution.

66 Section 6102(j)(2)(C) of H.R.11.

property.[67] A payor is not required, however, to sell employer securities to satisfy withholding obligations.[68] Nor is withholding required if a distribution consists solely of employer stock and cash (not in excess of $200) in lieu of fractional shares.[69] No withholding is required if a property distribution is not includable in income, such as occurs with the distribution of an annuity contract.[70] The temporary regulations do not exclude life insurance contracts from the definition of "eligible rollover distribution", and a number of commentators have requested relief.

[3] Net Unrealized Appreciation

Even though the amount of net unrealized appreciation (NUAP) on employer securities is not otherwise includable in gross income when employer stock is distributed in a lump sum distribution, the regulations clarify that the NUAP qualifies as part of an "eligible rollover distribution" and may be rolled over. Notice 93–3 clarifies that no withholding is required with respect to the "net unrealized appreciation (NUAP)," however, if the NUAP is distributed rather than directly rolled over.[71]

For plans with after-tax employee contributions, the correct manner of reporting the distribution on Form 1099-R is unclear when an employee directly rolls over the portion of the distribution equal to NUAP.

> *Example:* The participant is entitled to a lump sum comprised of 100 shares of company stock plus $10,000 cash. The employee has a basis of $5,000 and the stock is worth $7,000 (there is net unrealized appreciation of $2,000). The employee contributed $8,000 to the plan. Without a rollover, the Form 1099-R would show a distribution of $17,000; box 5 would show employee contributions of $8,000; box 6 would show net unrealized appreciation of $2,000, and box 2a would show a total taxable amount of $7,000 (calculated by taking the $17,000 distributed and reducing it by the $2,000 net unrealized appreciation and the $8,000 employee contribution).

---

[67] *See* Temp Treas. Reg. § 31.3405(c)–1T, Q&A 8.

[68] Treas. Reg. § 35–3405–1, Q&A 29.

[69] Temp. Treas. Reg. § 31.3405(c)–1T, Q&A 9.

[70] Code section 3405(d)(1)(B)(ii) ("designated distribution" does not include "the portion of a distribution or payment which it is reasonable to believe is not includable in gross income").

[71] Notice 93–3, 1993–3 IRB 11.

If the employee directs a rollover of $9,000, comprised of the $7,000 taxable amount and the $2,000 net unrealized appreciation, how is the remainder treated on the Form 1099-R? Should no net unrealized appreciation be shown because it was rolled over?

[4] Ordering and Allocation Rules

The proposed regulations fail to address a number of key issues involving the proper identification of distributed amounts, such as when cash and property is distributed. The picture is further clouded when employee contributions are involved.

Some recordkeepers are unable to accommodate elections where an employee wants to directly roll over some employer stock and keep some stock. These recordkeepers wish to impose plan ordering rules when there is a direct transfer. For example, when cash and employer stock are distributed, the direct rollover would first include the cash distributed and then the stock distributed. The temporary and proposed regulations permit the plan administrator to prescribe procedures for direct rollovers provided the procedure is reasonable and does not effectively eliminate the individual's ability to elect a direct rollover, so these kinds of ordering rules should be permissible.[72]

Since after-tax employee contributions are not included in a recipient's gross income, the plan administrator must decide how after-tax employee contributions are allocated when property is distributed. It is unclear how plan administrators are expected to make this allocation, given the provisions of Code section 402(c)(6)(C). When cash and property are distributed, Code section 402(c)(6)(C) applies and it permits the recipient to designate the allocation of employee contributions and the property as late as the tax return filing date. If an employee receives cash and employer securities, can the employee allocate all of his after-tax contributions to the cash and thereby limit the amount of withholding to the amount of the cash in excess of the employee contributions (because of the rule that does not require employer stock to be sold to satisfy the withholding obligations)? Is the withholding obligation limited to the total amount of cash or the amount of cash exceeding the employee's after-tax basis? The answers remain unclear.

---

[72] Temp Treas. Reg. § 1.401(a)(31)–1T, Q&A 6.

[5] Daily Valuation

When part of a distribution consists of property other than cash, the temporary regulations provide that the plan administrator must apply the provisions of Q&A F-1 through F-3 of Treasury Regulation § 35.3405–1 for purposes of applying the withholding rules.[73] These regulations permit the plan administrator to value the property as of the last preceding valuation date, or, where the most recent valuation date occurred within 90 days immediately preceding the date of distribution, as of the next most recent valuation date.[74] For plans that use daily valuation, any day may serve as a valuation date, although not all plan interests are valued on any certain date. Commentators have requested relief for these plans, such as allowing the plan administrator to use any valuation date within the 90-day period preceding the date of distribution.

§ 8.06 OTHER RECENT DEVELOPMENTS AFFECTING LUMP SUM TAXATION

[1] Affect of Rollovers on Lump Sum Taxation

Under Code section 402(c)(10), if a participant elects to rollover part of their balance from a plan, then the participant may not claim lump sum averaging with respect to any remaining balance to the credit of the participant. The expansion of the rollover rules in the UCA expands the importance of Code section 402(c)(10). If the participant rolls over a distribution, the participant will not be able to claim lump sum tax treatment for any subsequent distribution from that plan or any plan of the same type that is aggregated with the original plan.

[2] Affect of Pension Plan Transfers on Lump Sum Taxation

If part of a participant's account balance is transferred from one plan to another just before a participant takes a distribution from the transferor plan, it has been unclear whether the "balance to the credit" is determined before or after the asset transfer. Revenue Ruling 72–242 held that the "balance to the credit" is determined

---

73 Temp. Treas. Reg. § 31.3405(c)–1T, Q&A 8.

74 Treas. Reg. § 35.3405–1, Q&A F1.

before the asset transfer, but a series of private rulings reached the opposite conclusion.[75]

A 1991 private ruling reversed one of the earlier rulings on this question, however, and holds that the "balance to the credit" is determined before the asset transfer.[76]

[3] Multiple Lump Sum Distributions

If an individual receives two lump sum distributions in the same year, an individual electing five- or ten-year averaging must do so for all eligible lump sum distributions received during the same tax year, whether or not the lump sums were from plans of the same type or even from plans of the same employer. Two recent cases confirm that this rule means that a participant who receives two such lump sums in the same year may not rollover one of the lump sums while claiming lump sum averaging on the other lump sum.[77]

[4] Tacking Years of Service When Assets are Transferred in an "Elective Transfer"

When assets are transferred from one plan to another in a Code section 414(l) transfer, the IRS has held that the participant's service in the transferor plan may be counted or "tacked" with service in the transferee plan for purposes of satisfying the five-year minimum participation requirement of Code section 402(e)(4)(H).[78] There had been uncertainty whether the same rule applies to "elective transfers" under the Code section 411(d)(6) regulations, which are treated as "distributions" under those rules. In a 1990 private letter

[75] Rev. Rul. 72–242, 1972–1 C.B. 116 and private letter ruling 8529106 (April 26, 1985) hold that the transferred amount is included in the "balance to the credit," but private letter rulings 8814064 (January 16, 1988); 8950007 (September 13, 1989); and 9025092 (March 29, 1990) suggested otherwise.

[76] Private letter ruling 9025092, however, was reversed by private letter ruling 9139031 (July 3, 1991). Private letter ruling 9139031 holds that Rev. Rul. 72–242, *supra,* is still good law.

[77] *Fowler v. Commissioner,* 98 T.C. 503 (April 22, 1992) (taxpayer could not claim averaging for profit sharing plan lump sum when the taxpayer rolled over lump sum from savings plan). *Middleton v. U.S.,* No. 91–1011-RV-M (S.D. Ala., Feb. 25, 1993) (taxpayer could not claim averaging on profit sharing plan lump sum distribution when he rolled-over lump sum distribution received from money purchase pension plan). *See also* private letter rulings 8938081 July 3, 1989); 9003061 (October 24, 1989); and Prop. Treas. Reg. § 1.402(e)–2(e)(3)(a).

[78] Private letter rulings 8411114 (December 19, 1983) and 862082 (October 21, 1985).

ruling, however, the Service held that tacking of service occurs in an "elective transfer."[79] A "direct rollover" under the UCA rules is treated as a plan distribution, so there will be no tacking of service between the plans in such case.

[5] Balance to the Credit: Failed Investments

The IRS has issued a series of private letter rulings dealing with plans that have invested in guaranteed insurance policies (GICs) of insurance companies whose assets have been frozen because of state receivership proceedings. The question was whether a participant has received the full "balance to his credit" under the plan where the part of the participant's account attributable to the GIC could not be paid out because of the state receivership. In each case, the rulings cited Revenue Ruling 83–57[80] and held that the participant's remaining interest in the GIC was not part of the participants "balance to the credit," so that the participant was entitled to lump sum tax treatment.[81]

Two recent private letter rulings dealing with troubled real estate investment trusts (REITs) point up the fine-line distinctions made in this area. In both rulings, the market value of the REIT investments had dropped and the trustee imposed a freeze on payouts to avoid the precipitous sale of properties. When the trustee proposed to restructure the REIT by restricting withdrawals, a lawsuit was instituted to determine whether unanimous consent of all participating investors was required to consent to the withdrawal restrictions. Both private rulings distinguish Revenue Ruling 83–57 on the grounds that the litigation in the Revenue Ruling determined the exact value of accounts, whereas the litigation in the REIT case would determine only the permitted procedures for processing withdrawal requests.[82]

---

[79] Private letter ruling 9035078 (June 7, 1990).

[80] 1983–1 C.B. 92 (the ruling held that a distribution from a profit-sharing plan represented the "balance to the credit" of the employee even though an additional distribution representing the employee's portion of released court-impounded funds may be made in a subsequent year).

[81] Private letter rulings 9219042 (February 13, 1992); 9219043 (February 13, 1992); 9252034 (September 30, 1992); 9302028 (October 20, 1992).

[82] Private letter rulings 9137046 (June 20, 1991) and 9316047 (January 28, 1993).

§ 8.07 USING DEFINED BENEFIT PLAN DISTRIBUTIONS TO FUND MEDICAL BENEFITS

[1] Background

Many employers are reexamining the idea of using defined benefit plan payouts to fund retiree medical benefits on a pre-tax basis. The idea raises a number of tax issues, but seems to have promise. The basic legal argument in favor of the idea is that the pension distributions can be funnelled through a cafeteria plan with a "pension reduction" substituting for a "salary reduction."

[2] Plan Qualification Issues

Two plan qualification issues are raised by the idea of using defined benefit payments to fund a cafeteria plan.[83] First, is the medical benefit viewed as a benefit under the pension plan that fails to meet the "incidental benefits rule" of Code section 401? This rule limits the types of benefits that may be paid from a qualified pension plan and provides that medical benefits may be offered only as provided in Code section 401(h). Since the medical benefits would be offered under a so-called "check-off" arrangement, which seems to be contemplated by the Code section 401(a) regulations, it is difficult to see how the Service could argue that the medical benefit is provided by the pension plan.

The second plan qualification issue is whether the employee's direction to purchase retiree health coverage is a prohibited "assignment or alienation" under Code section 401(a)(13). The assignment and alienation regulations[84] permit a participant to re-direct plan

[83] Of course, the right to direct pension payments toward the purchase of retiree medical benefits must satisfy the nondiscrimination requirements of Code section 401(a)(4). The right to direct the pension payment toward the purchase of retiree medical benefits probably is a "right or feature" for purposes of the Code section 401(a)(4) regulations so the right would be tested on an availability basis.

[84] Treasury Regulation § 1.401(a)–13(e). It also can be argued that the arrangement is excluded from the definition of "assignment or alienation" as an "arrangement for the transfer of benefit rights from the plan to another plan" under Treasury Regulation § 1.401(a)–13(c)(2)(iv). Despite the broad wording, the Service might argue that this exception is limited to transfers from one qualified plan to another qualified plan. This exception appears to be based on the ERISA legislative history, which suggests such a limitation. See H. Rept. 93–807 (1974), 1974–3 C.B. (Supp) 236 at 303, and H. Rept. 93–779 (1974), 1974–3 C.B. 244 at 309 "(Of course, this provision is not intended to prevent the transfer of benefit rights from one qualified plan to another)."

payments to a third party, including the employer, provided the payment direction is revocable at any time and provided that the third party acknowledges in writing to the plan administrator that the payment direction is not an "assignment" and that the third party has no enforceable right to the benefit payment.

[3] Does the Medical Benefit Satisfy Code section 106?

There is authority holding that medical benefits are deemed to be "employer-provided" even if provided through a qualified plan trust. Private letter ruling 5710288190A held that premiums for medical insurance paid from employer contributions to a profit sharing plan were excludable employer contributions under section 106. General Counsel Memorandum 30304 (October 4, 1957) also noted as follows:

> In view of the fact that prior to the enactment of section 106 the position of the Service was that premiums paid by a trustee with employer contributions were treated the same as payments made directly by the employer, and since section 106 was sponsored by the Treasury with the apparent purpose of reflecting the position taken in G.C.M. 27281 (that employer-derived premiums paid by a trustee do not constitute realization of income), it is believed that the phrase "contributions by the employer" in section 106 includes amounts paid by a trustee with corpus contributed by the employer and earnings attributable thereto. Trusts qualified under section 401(a) are not exempted, since the statutory policy is to exclude all payments of premiums attributable to employer contributions.[85]

[4] Does the Arrangement Satisfy Code section 125?

The idea raises a number of issues under Code section 125. First, is it possible for former employees to participate under the cafeteria plan? Under the proposed cafeteria plan regulations it is clear that former employees may actively participate in a cafeteria plan, as long as the plan does not predominantly benefit former employees.[86] Surviving spouses receiving death benefits under the pension plan, however, would not be able to participate in the cafeteria plan. This is because the proposed cafeteria plan regulations limit spouses

[85] Gen. Couns. Mem. 30304 (October 4, 1957).

[86] Prop. Treas. Reg. § 1.125-1, Q&A 4.

and other beneficiaries to receiving benefits elected by the employee under the cafeteria plan.[87]

Another issue raised under the cafeteria plan rules is whether the arrangement violates the deferred compensation prohibition in Code section 125(d)(2). The deferred compensation prohibition under Code section 125, however, seems to apply only to deferred compensation received as a plan benefit and not to cafeteria plan contributions as a source of contributions.[88] Also, since it is clear that some number of former employees may continue to actively participate in a cafeteria plan, doesn't it prove too much to say that any cash payable to a former employee under a cafeteria plan is deferred compensation? Aren't all of the cafeteria plan benefits "deferred compensation" as to a former employee?

The final question under Code section 125 is whether the arrangement can satisfy the cafeteria plan 12-month irrevocable election requirement (subject to family status changes) when the exception to the anti-assignment rule of Code section 401(a)(13) requires the pension assignment to be "revocable at any time"? The proposed cafeteria plan regulations seem to offer a solution. Specifically, the regulation provides that a cafeteria plan may provide that a benefit will cease to be provided to an employee if the employee fails to make the required premium payments; if the employee does so, the plan must prohibit the employee from making a new benefit election for the rest of the period of coverage.[89] There have been informal indications that this exception was added to the cafeteria plan election rules to deal with state wage assignment laws which allow employees to cease wage assignments at any time, but the proposed regulation is not limited to cases where the participant is asserting such a state law right. Even if the regulation is revised, it would be possible to avoid the "revocable at any time" problem by restricting pension payouts. For example, the pension plan could be revised to pay the entire pension for the year on one day, rather than monthly. Here, the required revocability under the Code section 401(a)(13) would not come into play until the next annual payment is made.

---

[87] Prop. Treas. Reg. § 1.125–1, Q&A 4.

[88] Prop. Treas. Reg. § 1.125–1, Q&A-7; Prop. Treas. Reg. § 1.125–2, Q&A-5(a).

[89] Prop. Treas. Reg. § 1.125–2, Q&A 6(e).

[5] Does Section 72(p)(1)(B) override Code section 125?

Code section 72(p)(1)(B) states that if "a participant or beneficiary assigns (or agrees to assign) or pledges (or agrees to pledge) any portion of his interest in a qualified employer plan, such portion shall be treated as having been received by such individual as a loan from such plan." The participant's election is not an "assignment" for qualification purposes under the Code section 401(a)(13) regulations; however, it should not be an assignment under Code section 72(p)(1)(B).

[6] Does the Assignment of Income Doctrine Cause Taxability?

In two recent private letter rulings the Service applied the assignment of income doctrine in concluding that employees would be taxed when offered a choice between certain taxable and tax-free benefits.[90] Because of the types of benefits offered, neither arrangement could satisfy the Code section 125 requirements (one ruling involved a choice between deferred compensation payable in the future and current health coverage, and the other ruling involved a choice between current sick leave benefits and retiree health coverage). Code section 125, however, is broadly worded to protect against taxation under any theory or doctrine. The regulations are couched in terms of protecting against taxation under the constructive receipt doctrine, but the statute is not so limited. Presumably, the final Code section 125 regulations will be broadened in light of the theory adopted by the Service in private letter rulings 9104050 and 9227035.

[7] Withholding Tax

Assuming that periodic payments to participants under the pension plan are various life annuity options, the annuities would not be subject to the new 20 percent withholding rules and would be subject to the election-out withholding rules of pre-UCA law. Accordingly, the employer could have the employee elect out of withholding to the extent the participant elects to receive medical benefits under the defined benefit cafeteria plan.

---

[90] Private Letter Rulings 9227035 (April 9, 1992) and 9104050 (November 1, 1990).