VEDDER PRICE

Employee Benefits Bulletin

A review and analysis of recent developments affecting employee benefits

© 2000 Vedder, Price, Kaufman & Kammholz. The *Employee Benefits Bulletin* is published by the law firm of Vedder, Price, Kaufman & Kammholz. The discussion in this bulletin is general in nature and is not a substitute for professional advice. Reproduction of this bulletin is permitted only with credit to Vedder, Price, Kaufman & Kammholz. For an electronic copy of this newsletter, please contact Mary Pennington, Marketing Coordinator, at her e-mail address: mpennington@vedderprice.com.

Questions about the topics discussed may be directed to the firm's Employee Benefits Practice Group Leader, Paul F. Russell or any other Vedder Price Attorney with whom you have worked.

In This Issue:

New IRS Regulations Permit Plans to Eliminate Distribution Options

Cash Balance Plans: Two Federal Appeals Courts Rule Against Employers in Commonly Used Benefit Calculation Technique

Final and Proposed Regulations Address Tax Consequences of Violations of Plan Loan Rules

New Law Exempts Stock Options From Overtime Calculations

IRS Extends Plan Amendment Deadline and Opens Determination Program

Foreign Ownership of U.S. Companies and the Qualified Retirement Plan Controlled Group Rules

October, 2000

NEW IRS REGULATIONS PERMIT PLANS TO ELIMINATE DISTRIBUTION OPTIONS

On September 6, 2000, the Internal Revenue Service issued final regulations allowing employers broad discretion to modify defined contribution plans to eliminate participant distribution options. In most cases, employers can amend their 401(k) and

profit sharing plans to eliminate all distribution options except for a lump sum benefit. These new regulations reflect a substantial change in the IRS position and will allow employers to simplify plan administration. The regulations were effective September 6, 2000, so employers may amend their plans at any time.

Moreover, these regulations provide greater flexibility in transferring benefits between plans and in modifying in-kind benefit distributions.

However, these new regulations do not apply to defined benefit plans. Accordingly, employers may not amend defined benefit plans to eliminate distribution options except under pre-existing regulations.

Optional Forms of Benefit

Generally, the Internal Revenue Code prohibits plan sponsors from amending a qualified retirement plan to reduce participants' accrued benefits. Under prior regulations, this "anti-cutback" rule restricted an employer's ability to eliminate optional forms of benefits.

For example, some prototype profit sharing and 401(k) plans (particularly those offered by insurance companies) include an annuity as an optional form of distribution. Under prior regulations, when the employer amended the plan to a different prototype or other form of plan agreement, the employer could not eliminate the annuity form.

The new regulations allow amendments of defined contribution plans to eliminate distribution options, provided that the plan offers a lump sum distribution on the same terms and conditions as the eliminated option(s).

This planning option may be particularly attractive for employers burdened by numerous accounts and distribution options resulting from plan mergers following a business acquisition. For example, in many cases, employers can amend plans to combine plan accounts that previously had different distribution options, to simplify administration and record keeping.

However, money purchase pension plans must maintain a participant's right to a single-life or qualified joint and survivor annuity benefit. This rule also applies to those 401(k) and profit sharing plans that include former money purchase plan accounts following a plan merger.

In liberalizing these regulations, the IRS recognized that in most cases participants can rollover their benefit to an IRA and retain all of the options eliminated under a plan. For example, a participant could apply an IRA rollover distribution to purchase an annuity contract.

Notice Requirement

However, the new regulations preserve protections for employees who are planning for imminent retirement or other distributions that would be affected by a plan amendment eliminating distribution options. A plan amendment eliminating a multi-payment distribution option (*e.g.*, annuity) cannot be effective until at least 90 days after the employer notifies plan participants of the amendment by distributing a Summary of Material Modifications (SMM) describing the changes. Otherwise, the plan amendment could not be effective until the beginning of the second full plan year after the amendment is adopted.

Voluntary Transfers

The new regulations also liberalize rules governing participant elective benefit transfers between defined contribution plans. Previously, a participant could elect to transfer his benefit between plans only if the participant was eligible to receive an immediate distribution. Now, participants may transfer benefits between defined contribution plans even though benefits are not immediately distributable from the transferring plan.

This new transfer option is permitted in connection with a stock or asset sale, merger or other similar transaction involving a change in employer for employees of a trade or business. It also is permitted in connection with a change in the participant's employment status that terminates the participant's right to further plan contributions, such as a participant transfer to a subsidiary or affiliate not covered under the transferring plan. In either case, the plans must be the same type, such as a transfer between 401(k) plans, between money purchase pension plans or between two ESOPs.

As provided under pre-existing regulations, the transfer must be completely voluntary and only after the participant makes a fully informed election acknowledging the consequences of the transfer. Alternatively, the participant could be offered a right to retain any benefits that otherwise would be eliminated as a result of the voluntary transfer (*e.g.*, the right to an installment payment distribution option in a transfer between 401(k) plans).

Although an elective transfer may involve unvested benefits, the participant's vested percentage may not be reduced, and participants with three years of service may select the vesting schedule provided under either plan.

In-Kind Transfers

The new regulations also provide greater flexibility in making distributions to participants in cash or in kind. The regulations allow employers to amend a plan to pay an annuity in cash rather than distribute an annuity contract, and to distribute cash in lieu of marketable securities. However, the plan may not be amended to require a participant to take a distribution in cash in lieu of employer securities. That restriction notwithstanding, a plan that includes employer securities as a participant investment option may be amended to eliminate that option so that the employer securities are sold and not distributed to participants.

Conclusion

The new regulations are considerably more flexible by allowing employers to an eliminate distribution options. Doing so can simplify plan administration and reduce plan expenses with minimal impact on participants. Accordingly, employers should review their plans and business needs to determine whether an amendment may be appropriate.

Robert F. Simon

Return to Top of Document

CASH BALANCE PLANS: TWO FEDERAL APPEALS COURTS RULE AGAINST EMPLOYERS IN COMMONLY USED BENEFIT CALCULATION TECHNIQUE

The Eleventh Circuit Federal Court of Appeals in Atlanta and the Second Circuit Federal Court of Appeals in New York recently issued important decisions against employers who used a common procedure for paying lump sum distributions from their cash balance pension plans. These decisions could significantly

affect the administration and payment amount in computing a participant's lump sum distribution from a cash balance plan.

Cash Balance Plans

Cash balance plans are a new form of defined benefit plan created by consultants that provide a guaranteed benefit, but have features similar to defined contribution plans. Typically, these plans state a participant's accrued benefit in the form of a hypothetical account balance similar to a defined contribution plan, but provide a guaranteed rate of return (or interest credit). These plans have generated a good deal of controversy lately as many large employers have been converting their traditional defined benefit pension plans to cash balance plans. Much of this controversy has centered on whether switching to a cash balance plan reduces future accrual rates for certain groups of older participants who otherwise may receive higher accrual rates toward the end of their careers with an employer under traditional defined benefit pension plans. Many employers believe that, with today's more diverse workforce, it is preferable to provide a more even rate of pension accrual throughout an employee's career. *(See the April 2000 Vedder Price Employee Benefits Bulletin for details.)*

Lump Sum Distributions

The two court decisions focus on whether it is appropriate for a cash balance plan to merely pay out the stated amount in a participant's cash balance account without taking further steps that the Internal Revenue Service believes is necessary to comply with existing regulations on computing lump sum distributions in a defined benefit plan. These regulations interpret statutory requirements under ERISA and the Internal Revenue Code to require a defined benefit plan to use certain interest rates for calculating lump sum distributions. Under current law, this interest rate is commonly referred to as the *GATT rate*, and is based on the yield on 30-year U.S. Treasury securities (GATT also requires the use of a specific mortality table). Under prior law, the interest rate was commonly referred to as the *PBGC rate*, and a plan was permitted to use 120% of the PBGC rate for lump sum distributions above $25,000. As discussed below, using these rates in a cash balance plan typically results in a higher lump sum payout than the stated amount in a participant's cash balance account.

Both appeals courts overturned decisions by district courts that were much more favorable to employers sponsoring cash balance plans and recognized that existing law is in many respects

inconsistent with the design and purpose of cash balance plans.

Lyons v. Georgia Pacific Corp. Salaried Employees Retirement Plan (Eleventh Circuit)

The Eleventh Circuit case was *Lyons v. Georgia Pacific Corp.* Salaried Employees Retirement Plan. In this case, the participant received a lump sum distribution of his stated cash balance account and sued the employer and the plan, claiming that he did not receive the actuarial equivalent of his full accrued benefit under the plan. The participant pointed to Internal Revenue Service guidance on cash balance plans indicating that, to comply with the regulations, a cash balance plan must, first, convert a cash balance account into an annuity payable at age 65 by using the plan's interest rate and, second, determine the present value of the annuity by using the interest rate required by the law for calculating lump sum distributions in a defined benefit plan. When the latter rate is lower than the plan's rate, the resulting lump sum amount is higher than the cash balance account. Consequently, the participant in *Lyons* claimed that he did not receive the full amount of his accrued benefit, in violation of ERISA.

The district court ruled against the participant and found that the regulations in question were unreasonable in the context of cash balance plans. However, the Eleventh Circuit overruled the district court and upheld the regulations, thus deferring to the interpretation of the Internal Revenue Service. As a result, it was determined that the participant was not paid the full present value of his accrued benefit and was entitled to an additional payment from the plan.

Edsen v. Bank of Boston (Second Circuit)

The Second Circuit case was *Edsen v. Bank of Boston*. In this case, the plan provided a guaranteed interest credit for a plan year between a minimum of 5.5% and a maximum of 10% (the actual interest rate used for a year was based on conditions in the bond market). After the participant separated from service, she requested a distribution. Under these circumstances, the plan provided that the participant's cash balance account is converted into an annuity payable at age 65 by using a 4% interest rate and, if a lump sum distribution is requested, the annuity is converted into a lump sum present value amount by using a 4% interest rate. Since both interest rates are the same, the net effect is that the lump sum distribution is the same as the cash balance account.

The participant sued and lost at the district court level. That court

found that the participant received what she was promised under the plan and that using the Internal Revenue Service's approach would be inconsistent with the purpose behind a cash balance plan. The Second Circuit overturned the lower court's decision, and held that, by not converting the cash balance account into an annuity by using the minimum guaranteed interest rate under the plan of 5.5%, the plan was essentially forfeiting a portion of the participant's accrued benefit. (Had the participant not elected to receive a lump sum distribution, her cash balance account would have grown at a minimum rate of 5.5% and not 4% per year.) Consequently, the appeals court held that the lump sum distribution paid to the participant, while representing her full cash balance plan account, did not represent the full present value of her accrued benefit as required by ERISA and the applicable regulations.

While the Second Circuit stated that existing regulations "do not always fit in a clear fashion with cash balance plans," it also noted that these plans are not free to choose their own methodology for calculating lump sum distributions.

Many new cash balance plans follow Internal Revenue Service safe harbor rules that were issued after the plans above were adopted. These rules permit a plan to avoid the complicated actuarial calculations discussed above if the interest crediting rate is within certain specified ranges. However, these ranges are typically on the lower side (they tend to be close to the yield on U.S. Treasury securities). It is ironic that plans that provide a higher interest crediting rate, and, thus, a higher promised benefit to participants, find themselves in this dilemma as opposed to plans that provide a lower interest crediting rate, and, thus, a lower benefit amount, by following the Internal Revenue Service safe harbor rules.

Conclusion

Since cash balance plans were created by consultants and not Congress, there are no special provisions made for them in ERISA or the Internal Revenue Code. Many consultants were pleasantly surprised when the two favorable district cases were released, as they demonstrated flexibility by the courts in applying existing laws to new pension developments. However, the two appeals court reversals show that there are risks inherent with adopting new approaches that are inconsistent with current legal guidelines. In a highly technical field like pension law, the courts often defer to legal interpretations issued by governmental agencies with regulatory authority over a specific legal issue. Ultimately, that is exactly what happened in these two cases.

Mark I. Bogart

Return to Top of Document

FINAL AND PROPOSED REGULATIONS ADDRESS TAX CONSEQUENCES OF VIOLATIONS OF PLAN LOAN RULES

The IRS has issued final regulations governing plan loans to participants, as well as further proposed regulations addressing related issues. In 1995 and 1998, the IRS issued proposed regulations governing the qualification of plan loans and treatment of participant defaults and other violations of these rules.

While the new final regulations leave the prior rules substantially intact, it may be an opportune time for employers to review plan loan procedures to confirm that they comply with the new regulations.

For example, as provided under the proposed regulations, a participant default of a plan loan may be cured to avoid a deemed taxable distribution. Under the final regulations, the participant must cure the default within three months or, if the plan so provides, by the last day of the next calendar quarter.

In the event of a deemed distribution following a participant's default, the loan nevertheless is treated as outstanding and continues to accrue interest. Although the continuing interest accruals are not taxable, the outstanding debt will reduce the amount that the participant could borrow in the future. After a deemed distribution, repayments of loan principal and interest are taken into account as after-tax amounts when distributed from a participant's account balance, thereby avoiding double taxation of the loan amount.

Among the rules provided under the new proposed regulations, participants may not receive more than two loans per year. This rule is designed to prevent participants from paying loan installments with the proceeds of a new loan, so that participants cannot avoid the statutory limits. Additionally, any loan refinancing which extends the maturity date will be treated as two

loans outstanding, together subject to the statutory limits. If the combined loan amounts exceed the statutory limits, then the excess will be treated as a taxable deemed distribution.

Although the final and new proposed regulations provide a number of mostly minor changes, employers should review their loan procedures to determine if revisions are warranted.

Robert F. Simon

Return to Top of Document

NEW LAW EXEMPTS STOCK OPTIONS FROM OVERTIME CALCULATIONS

Employers and their payroll departments can breathe a sigh of relief with the enactment of new legislation that clarifies the treatment of stock options under the Fair Labor Standards Act (FLSA). The "Worker Economic Opportunity Act," which was fast-tracked through Congress, effectively annuls a controversial opinion letter issued by the Department of Labor (DOL). The DOL contended that, for non-exempt employees, employee gains upon exercise of their stock options must be included in base pay for "time and one-half" overtime calculations. As a result, under the DOL view, employees exercising stock options and earning overtime would receive what most employers viewed as an unintended windfall. *(See the April 2000 Vedder Price Employee Benefits Bulletin for details.)*

The Act, however, excludes the value and income of most stock-based compensation from an employee's "regular rate" of pay, exempting such compensation from the computation of his or her overtime rate. Thus, the new law substantially removes the uncertainty caused by the DOL's advisory opinion. The Act was effective August 16, 2000.

Programs Covered by the Act

The Act provides that any value or income derived from employee stock option, stock appreciation rights, or employee stock purchase programs is excluded from an employee's regular rate of pay if the following apply:

- The terms and conditions of the program are communicated to participating employees upon initial participation in the program or at the time of a succeeding option grant;

- Grants of stock options or stock appreciation rights are not exercisable for at least six months (excepting certain changes of employment status), and the exercise price must be at least 85% of the fair market value of the stock at the time of the grant; and

- The exercise of any grant or right is voluntary.

- Additionally, any determinations regarding awards based on employee performance require:

- Meeting previously established performance criteria (such as hours of work, efficiency, or productivity) of a business unit with at least 10 employees or a facility of any size, except that any determinations may be based on length of service or minimum schedule of hours or days of work; or

- Past performance (which may include any criteria) of one or more employees in a given period, so long as the determination is in the sole discretion of the employer and not pursuant to any prior contract.

Employer Liability

The Act specifically exempts from liability those employers who failed to include any income or value from stock-based compensation in an employee's regular rate of pay for overtime calculations, as suggested by the DOL opinion letter, if the following criteria are met:

- The grants or rights were obtained before August 16, 2000;

- The grants or rights were obtained within the 12-month period beginning on August 16, 2000, provided that the program existed on May 18, 2000, and requires shareholder approval to modify the program to comply with the new amendments to the FLSA; or

- The program is provided under a collective bargaining agreement that is in effect on August 16, 2000.

Employers sponsoring stock-based bonus plans, or who are considering adopting or expanding such plans, should review their programs in light of the new law to ensure proper

compliance to exclude such compensation from their non-exempt employees' computation of overtime pay.

Charis A. Runnels

Return to Top of Document

IRS EXTENDS PLAN AMENDMENT DEADLINE AND OPENS DETERMINATION PROGRAM

The IRS has extended the deadline for updating qualified plans (other than government plans) to reflect changes in the law since 1994. Employers must update their qualified plans by the last day of the plan year beginning in 2001. For calendar year plans, the deadline is December 31, 2001. Additionally, the IRS very recently opened its favorable determination program for plans incorporating these amendments (so-called "GUST Amendments," based on an acronym for the applicable laws adopting those changes).

Since 1994, there have been numerous changes to the Internal Revenue Code that affect the continuing qualification of pensions, profit sharing and 401(k) plans, many of which we described in previous Bulletins. Among these changes are new and revised methods of discrimination testing for 401(k) plans, the method of identifying "highly compensated employees," the repeal of the "family aggregation" rule, allowing age 70½ mandatory distributions to be eliminated for active employees (other than 5% owners), the method of computing lump sum distributions from defined benefit plans, the repeal of the combined plan limits (the "Section 415(e) limit"), and increasing the mandatory cash-out distribution limit from $3,500 to $5,000.

Most such changes were effective prior to 2000, but may be adopted under an updated plan document, with retroactive effect, if the plan was administered after the effective date in a manner consistent with such changes. Additionally, many plan sponsors had postponed their plan updates awaiting IRS guidance on the elimination of alternative distribution options, which was issued very recently, as discussed above. Due to the scope of the changes, employers generally are restating their plans in the entirety.

On June 26, 2000, the IRS opened its full determination letter program for all GUST Amendments. Previously, the IRS would not issue a favorable determination letter for any GUST Amendments that were effective after December 31, 1998.

While not legally required, employers should consider submitting their updated plans to the IRS for a favorable determination letter. At the time that plans are updated, it also may be advisable to conduct a self-audit of plan operations to confirm whether the plans were correctly administered since the last determination letter and whether any correction may be appropriate.

The procedures for updating and submitting plans to the IRS are described in Revenue Procedure 2000-27, 2000-26 I.R.B. (6/26/2000) and Announcement 2000-77, 2000-36 I.R.B. (9/5/2000). Under this procedure, the IRS advised that it would not issue determination letters addressing the elimination of alternate benefit options until regulations are finalized. Although the IRS has not officially addressed this question further, it should be possible for employers to obtain a favorable determination on these matters since the adoption of final regulations on September 6, 2000.

Accordingly, under the new IRS determination program, employers may fully update their plans now and submit the plans to the IRS for approval on all matters. In all events, plans should be updated by the end of the plan year beginning in 2001 and submitted to the IRS if a determination letter is desired.

Robert F. Simon

Return to Top of Document

FOREIGN OWNERSHIP OF U.S. COMPANIES AND THE QUALIFIED RETIREMENT PLAN CONTROLLED GROUP RULES

In today's multinational business environment, U.S. employers of foreign parent companies must consider the impact of rules governing employer controlled groups for qualified plan coverage testing and other purposes. Cross-border business acquisitions are continuing at a hectic pace. Many foreign conglomerates have

About Vedder Price

Vedder, Price, Kaufman & Kammholz is a national, full-service law firm with approximately 190 attorneys in Chicago, New York City and Livingston, New Jersey.

The Employee Benefits Group

Vedder Price has one of the nation's largest employee benefits practices, with ongoing responsibility for the design, administration and legal compliance of pension, profit sharing and welfare benefit plans with aggregate assets of several billion dollars. Our employee benefits lawyers also have been involved in major litigation on behalf of benefit plans and their sponsors. Our clients include very large national corporations, smaller professional and business corporations, multi-employer trust funds, investment managers and other plan fiduciaries.

Employee Benefits Group: <

Mark I. Bogart 312/609-7878
Thomas P. Desmond 312/609-7647
Thomas G. Hancuch 312/609-7824
John J. Jacobsen, Jr. 312/609-7680
Neal I. Korval 212/407-7780
Philip L. Mowery 312/609-7642
Paul F. Russell 312/609-7740
Robert F. Simon 312/609-7550
Kelly A. Starr 312/609-7768
Jonathan A. Wexler 212/407-7732
Charles B. Wolf 312/609-7888

Vedder, Price, Kaufman & Kammholz
A Partnership including Vedder, Price,

diverse holdings in the United States, and many allow their U.S. companies to operate with a good degree of autonomy. As such, many of these U.S. companies have different qualified retirement plans and lack information about the plans of other U.S. companies owned by their foreign parent. However, regulations provide that all U.S. companies owned by a common parent, domestic or foreign, are considered to be a single employer under the qualified retirement plan controlled group rules. Therefore, these U.S. companies should perform their annual minimum coverage testing for their plans by including all U.S. employees under the control of their foreign parent.

This article discusses the controlled group rules as they apply to qualified retirement plans and foreign conglomerates. Although this article briefly summarizes the minimum coverage test, a detailed discussion of that test is beyond the scope of this article.

Background of Controlled Group Rules

The basic controlled group rules are found in Section 1563(a) of the Internal Revenue Code, and generally apply for purposes of determining whether a group of related corporations can file a consolidated federal corporate income tax return. In general, a controlled group exists under either: (1) a parent-subsidiary arrangement, where one corporation owns, directly or indirectly, at least 80% of another corporation, or (2) a brother-sister arrangement, which has a two- part test requiring the same five or fewer individuals, estates or trusts to have: (a) a combined ownership interest of at least 80% of each corporation, and (b) a common ownership interest in each corporation of more than 50%. Under Section 1563(b), only "component members" of a controlled group are covered, and foreign corporations are excluded from being a component member. Consequently, U.S. companies that are related only through foreign ownership may be part of a controlled group under Section 1563(a), but may be excluded under Section 1563(b). Since Section 1563 applies only to corporations, other business forms (such as partnerships or LLCs) cannot be part of a controlled group.

Qualified Plan Controlled Group Rules

However, the Internal Revenue Service applies the controlled group rules more broadly for qualified plans. The controlled group rules for qualified retirement plans are found in Sections 414(b) and 414(c) of the Internal Revenue Code. These Code sections do not actually define a controlled group, but authorize regulations defining a qualified plan controlled group based on criteria that apply to the basic controlled group rules under

Kaufman & Kammholz, P.C.

Chicago
222 North LaSalle Street
Chicago, Illinois 60601
312/609-7500
Facsimile: 312/609-5005

New York
805 Third Avenue
New York, New York 10022
212/407-7700
Facsimile: 212/407-7799

New Jersey
354 Eisenhower Parkway
Plaza II
Livingston, New Jersey 07039
973/597-1100
Facsimile: 973/597-9607

Section 1563(a), described above. Apparently, due to the fact that foreign corporations are excluded under Section 1563(b) of the Code, and not under Section 1563(a), the Internal Revenue Service believes that foreign companies are not excluded from the qualified plan controlled group rules under Sections 414(b) and 414(c). The term "foreign companies" is significant because, under Section 414(c), the qualified retirement plan controlled group rules apply to all types of businesses (corporations and unincorporated entities). In the absence of further legal authority, employers having a foreign parent should be mindful of these aggregation rules and the impact on their qualified retirement plans.

Although an employer may not be a part of a controlled group under the ownership tests above, it nevertheless may be included in an *affiliated service group* under Section 414(m) of the Code, based on certain services provided by one employer to another. In that case, all employees in the affiliated service group must also be included in performing the minimum coverage test. The application of the affiliated service group rules is complex and beyond the scope of this article.

Impact on Minimum Coverage Test

For each plan year, a qualified retirement plan must pass the minimum coverage test under Section 410(b) of the Internal Revenue Code. The minimum coverage test can be met either under the *ratio percentage test* or the *average benefits test*. In general, the test is performed by including all U.S. domestic employees in the controlled group, although certain employees can be excluded (such as those under age 21, with less than one year of service or who are members of a collective bargaining unit). Thus, the composition of the employer group under the controlled group rules could affect whether the plan passes this test. In addition, defined benefit pension plans must also pass a minimum participation test for each plan year under Section 401 (a)(26) of the Internal Revenue Code.

If a plan can pass the minimum coverage test, then generally it need not be aggregated with other plans in the controlled group. That is, different plans within the controlled group can have different benefit levels as long as each plan passes the minimum coverage test.

The easier method to pass the minimum coverage test is by using the ratio percentage test. In general, this test: (1) determines the percentage of highly compensated employees in the controlled group who are active participants in a plan, (2) determines the

same percentage for nonhighly compensated employees, and (3) divides the percentage in (2) by the percentage in (1). As long as the resulting figure in step (3) is at least .70, the test is met. If the result is below .70, then the employer must apply the more complicated average benefits test or look at other alternatives (such as plan aggregation or the separate line of business rules).

The problem for many U.S. companies having foreign parents is that they often lack access to employee data for the other U.S. companies in the controlled group. This makes it difficult to gather the data to perform the minimum coverage test consistent with the regulations. Since data on the minimum coverage test must be provided each year on the Form 5500, and on Form 5300 when a plan is filed with the IRS for a determination letter, this data should be compiled as accurately as possible.

Other Implications

In addition to the tests mentioned above, employers should consider a few other qualified retirement plan rules when there is a controlled group (even if each plan passes the minimum coverage test). The following is a brief list of these rules:

- If a highly compensated employee participates in more than one 401(k) plan in the controlled group, then such employee's contributions to all plans must be combined in performing the actual deferral percentage test (or ADP test) for each plan. The same rule applies to the actual contribution percentage test (or ACP test) for matching contributions and employee after-tax contributions.

- Except in the event of hardship or the attainment of age 59-½ , distributions cannot be made from a 401(k) plan before a participant separates from service with all of the companies in the controlled group. Accordingly, an employee who is transferred to another company with a new plan is not yet eligible to receive a distribution from his or her original employer's 401(k) plan.

- The maximum benefit and contribution limits that apply to qualified retirement plans under Section 415 of the Code are performed by combining all plans in the controlled group. However, for purposes of this rule, a parent-subsidiary controlled group exists if the parent owns more than 50% of the other company (instead of "at least 80%").

- The maximum amount of a loan that a participant can receive from a plan is based on all outstanding loans to the

participant from all plans in the controlled group.

- Certain liabilities relating to unfunded defined benefit plans and multi-employer plans are imposed on all members of the controlled group on a joint and several basis.

Final Observations

Some practitioners have argued that the regulations on foreign parent companies under the qualified retirement plan controlled group rules are incorrect. Although this matter has not been litigated, an argument can be made in support of the regulations. Moreover, judges often defer to legal interpretations by the government agency having regulatory authority over a specific legal issue. Therefore, although it is possible that the regulations could be overruled by a court if challenged, there remain legal risks in disregarding the effect of these regulations in the absence of further authority. Moreover, there should be very few additional plan administrative burdens associated with following these regulations other than gathering the necessary data for the minimum coverage test, particularly if employees are not transferred between different companies within the controlled group or are not simultaneously employed by different companies. Accordingly, observance of the controlled group rules should ensure that employers are performing their minimum coverage testing consistent with the regulations.

Mark I. Bogart

- Return to theEmployee Benefits index.
- Return to the Vedder Price Publications Page.
- Return to: Top of Page.

© 2000 Vedder, Price, Kaufman & Kammholz
Please read our disclaimer.