THE Pension Digest

Published Since 1984 Collin W. Fritz and Associates, Inc., *"The Pension Specialists"* November, 1996

TRANSITIONAL RELIEF FROM SIMPLE 60-DAY ELECTION REQUIREMENT

The IRS has recently issued Announcement 96-12. This Announcement provides transitional relief from the 60-day election period which is statutorily required with respect to a SIMPLE plan. The IRS makes clear that this announcement applies to those SIMPLE plans that begin January 1, 1997. The IRS states that further guidance will be provided for SIMPLE plans established for 1997 that are first effective after January 1, 1997. Thus, it appears that the IRS will adopt a rule that a 1997 SIMPLE plan need not start on January 1, 1997, it could be started later.

Why the need for this transitional relief?

It is already the middle of November, and January 1, 1997, is less than 45 days away.

Section 408(p)(5)(C) provides that for each calendar year each eligible employee may elect, during the 60-day period before the beginning of the calendar year (and the 60-day period before the first day the employee is eligible to participate), to participate in the qualified salary reduction agreement under the SIMPLE plan, or to modify his or her previously furnished instruction. The law also requires the employer to notify each eligible employee within a reasonable period before this 60-day election period, of the employee's opportunity to make such salary reduction contributions, the level of the employer's matching contribution and certain other information.

The IRS has issued a special transitional rule — the 60-day election period will not be required (but will be permitted) to begin before January 1, 1997, but will be required as modified.

There is still a notice requirement, and the election period cannot begin until notice of their opportunity to make salary-reduction contributions is provided to all eligible employees. This notice requirement includes the summary description which is required by the statute. See the enclosed Form 918 with respect to this summary description.

For plans that begin before January 1, 1997, the 60-day election period requirement can be satisfied by providing an election period, of at least 60 days, that includes either the date the employee becomes eligible to make salary reduction contributions, or the day immediately before that date. Thus, in the case of SIMPLE, which intends to commence salary reduction contributions on January 1, 1997, the employees who are eligible employees as of that date must have an election period of at least 60 continuous days. This election period will commence somewhere between November 2, 1996, and January 1, 1997.

Thus, the 60-day election period will range somewhere between the following: (1) November 2, 1996, to January 1, 1997 and (2) January 1, 1997, to March 2, 1997. For example, it could also be the period of December 1, 1996, to January 29, 1997.

The special relief is that the employer may permit an eligible employee to begin making salary-reduction contributions less than 60 days after receiving the notice, but in no event before January 1, 1997. Although the employee is not required to wait the full 60-day period before commencing deferrals, he or she must be given the opportunity to prospectively modify the election during the remainder of the 60-day election period.

Example: An employer could furnish the required notice on or before December 31, 1996. Then an employer could allow eligible employees to commence salary-reduction contributions on January 1, 1997. However, such employees would have until March 2, 1997, to modify his or her election.

This special IRS transitional relief will mean that qualifying employers should be able to start their SIMPLE plan so that it can start as of January 1, 1997. PD

IRS Issues Form 5305-SIMPLE and the IRS is Soon to Issue Form 5305-S

(SIMPLE IRA Custodial Plan Agreement)

The IRS has issued the Form 5305-SIMPLE so employers can now establish a SIMPLE to commence January 1, 1997. Under this form, employers will also be able to wait and establish the SIMPLE plan later in the year if they wish.

The IRS has also indicated that they will not be revising the Form 5305-A or Form 5305, but rather they have chosen to create two new forms for the SIMPLE IRA — one for custodial accounts and one for trust accounts. These two forms should be available within the next 10-20 days. Employees will use this form to establish their SIMPLE IRA.

The IRS has a certain amount of discretion in drafting any form and the Form 5305-SIMPLE shows some of that discretion. The contents of the form follows very closely the statutory provisions, but the IRS did exercise its discretion in some interesting ways.

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5305-SIMPLE—*Continued from page 1*

The Form 5305-SIMPLE is six pages. Pages one and two comprise the plan. Page three sets forth a model notice salary reduction agreement. Pages four through six are the instructions. Pages one and two are enclosed.

Here are our observations about the form and the instructions to the form.

1. Although the statutory language requires that the SIMPLE plan be a calendar year plan, the IRS had adopted the approach that the plan's initial effective date need not be January 1 if this is the first year for which an employer is adopting the SIMPLE plan. An employer will be able to choose, as its effective date, any date between January 1, 1997, and October 1, 1997. For example, an employer could elect to have its SIMPLE plan be first effective as of March 1, 1997.

2. In the same fashion, the IRS has adopted the approach that an employee's 60-day election period need not always be November 2 to December 31 for the first year in which an employee becomes eligible to make salary reduction contributions. For this first year, the 60-day election period may either commence on the date the employee first becomes eligible (i.e. date of hire if no eligibility requirements) or the day immediately before such day.

For years other than the year the employee first becomes eligible, the 60-day period during which the employee may make or modify his or her elections is November 2 to December 31.

3. This form can only be used if an employer is willing to require that all SIMPLE plan contributions initially go to one particular financial institution. Such contribution must be deposited to the SIMPLE IRA of each eligible employee.

If an employer wishes to give the right to its employees to invest their SIMPLE contributions to a SIMPLE IRA of their own choosing, a different plan document will need to be used. Be aware that CWF will have such a document.

4. An employer may choose to make all employees eligible to participate in the SIMPLE, or it may impose the compensation limits allowed by the statute. The IRS has written the form so that the compensation limit may be set in the range of $0 - $5,000, and the prior year limits may be set in the range of 0 - 2 years. An employer may choose to not exclude as many employees as the statute would permit.

5. The form, as drafted, excludes all nonresident alien employees, a reasonable approach since the inclusion of such employees would only apply to a small minority of employers. Employers may also elect (but they need to do it affirmatively by checking a box) to exclude union employees, but only if retirement benefits were bargained for within the collective bargaining agreement.

IRS ISSUES 1997 COLAS

IRS Announces Cost-of-Living Adjustments for 1996

The IRS in News Release 99-43 has released its 1997 adjustments as follows:

	1995	1996	1997
Taxable Wage Base	$61,200	$62,700	**$65,400**
SEP and Qualified Plan Maximum Compensation Cap	$150,000	$150,000	**$160,000**
Excess Distribution Tax Threshold	$150,000	$155,000	**$160,000**
Elective (Salary) Deferral Limit - 401(k) & SAR-SEP	$9,240	$9,500	**$9500**
Highly-Compensated Employees (Compensation as indexed)			
Compensation in excess of $75,000	$100,000	$100,000	**N/A**
Compensation in excess of $50,000/Top Paid Group	$66,000	$66,000	**N/A**
New Definition as of January 1, 1997	**N/A**	**N/A**	**$80,000**
Defined Benefit Limit – Section 415(b)	$120,000	$120,000	**$125,000**
Defined Contribution Limit – Section 415(c) (The annual defined contribution plan limit is $30,000 as indexed and will not change until the defined benefit amount exceeds $120,000.)	$30,000	$30,000	**$30,000**
SEP Minimum Compensation Threshold	$400	$400	**$400**
Officer Amount – Top Heavy	$60,000	$60,000	**N/A**
Top 10 Owner Group – Top Heavy (Has more than one-half percent and the largest ownership interest and income in excess of $30,000.)	$30,000	$30,000	**N/A**
1% Owner – Top Heavy (Having annual compensation in excess of $150,000.)	$150,000	$150,000	**N/A**
Simple Contribution Limit	**N/A**	**N/A**	**$6,000**

6. For purposes of determining who is an employee and whether the compensation requirements have been met, the standard controlled group rules will need to be applied.

7. An employer may, but need not, allow an employee to start or modify a previous salary-reduction instruction. By law, an employee must have the right to stop his or her salary-reduction contributions. If the employer does not wish to give an employee who has stopped his or her salary-reduction contributions the right to resume such contributions, then he or she must affirmatively check a box.

8. The IRS has written the form to include the statutory requirement that an employer must make the salary-reduction contributions to an employee's SIMPLE IRA no later than 30 days after the end of the month in which the money is withheld from the employee's pay.

The Department of Labor (DOL) has informed the IRS that notwithstanding this "new" statutory language, they feel an older and more stringent rule applies. The DOL has concluded that most SIMPLE plans are subject to Title I of ERISA. Therefore, the DOL has adopted the position that an employer under a SIMPLE plan, as with 401(k) plans, must contribute the salary reduction contributions to the employee's SIMPLE IRA as of the earliest date on which those contributions can reasonably be segregated from the employer's general assets, but in no event later than the 30-day deadline described by the statute. As with other retirement plans, the DOL's position is that "one-person" retirement plans are not Title I plans.

9. The instructions contain the comment that a SIMPLE plan may be established by using the IRS Model Form 5305-SIMPLE or by any other document which satisfies the statutory requirements. It will be interesting to see if the IRS develops a prototype program for SIMPLEs, or some type of ruling program.

10. The Form 5305-SIMPLE does not really address the issue of how and when an employer who originally elects to sponsor a SIMPLE plan may change its mind. The statute gives the definite impression that an employer's sponsorship of a SIMPLE plan can be done on a year-to-year basis. The IRS needs to furnish additional guidance on this subject.

11. The IRS will be providing additional discussion of SIMPLE plans in both Publication 560, "Retirement Plans for the Self-Employed" and Publication 590, "Individual Retirement Arrangements." PD

IRS Issues QP Model Amendment

The IRS has issued Rev. Proc. 96-49 which provides a model amendment that will give plan sponsors a streamlined way to amend their plans to comply with the requirements of the Uniformed Services Employment and Reemployment Rights Act of 1994 (USERRA) and Internal Revenue Code section 414(u) as added by the Small Business Job Protection Act of 1996. In general, plans will not need to be amended for these law changes before 1998. Those employers that have adopted either a qualified plan or a SEP via a prototype, volume submitter plan or an individually designed plan which has received a favorable opinion, determination or ruling on account of TRA 86, will be able to use a model amendment to accomplish this amendment requirement task. CWF will be informing its prototype users of the availability of this model amendment. The very brief model amendment is set forth at the end of this article.

USERRA revised and restated the federal law governing reemployment rights. One of those rights deals with the employee's right to receive upon reemployment, certain pension, profit sharing and similar benefits under either defined benefit or defined contribution plans that would have been received but for the employee's absence during military service.

Section 414(u) generally provides that a contribution that is made by an employer or employee participant pursuant to USERRA is taken into account for various purposes of the limitation rules in the year to which the contribution relates and not the year in which the contribution is made. Prior law required the testing to be done for the year the contribution was made, and this caused compliance problems. In addition, the various nondiscrimination rules will not be violated as a result of these contributions or the right to make such contributions.

USERRA gives a person who has served in the military the following pension rights. His or her absence does not result in a break in service. His or her military service time is treated as service with the employer for benefit accrual and vesting purposes. He or she is permitted to make additional elective deferrals or nondeductible employee contributions in an amount not exceeding the maximum amount he or she would have been permitted or required to contribute during the period of military service if the employee had actually been employed by the employer during that period. And the employer must make any promised matching contributions if the employee makes his or her contribution. The employee in general must be permitted to make his or her make-up contributions for five years commencing on his or her date of reemployment. This five-year period is reduced to three times the respective military service period, if that would result in a time period of less than five years.

Section 414(u) provides that an employee is treated as receiving compensation, an amount equal to the compensation which the employee otherwise would have received from the employer during the period of military service. If this amount is not reasonably known, then the employee's average compensation from the employer for the time immediately preceding the service would be used. The plan is not required to allocate earnings before the contribution is actually made, nor is the employee entitled to share in an allocation of forfeitures. A plan will be able to suspend an employee's obligation to repay a loan for any part of military service if it so chooses, and the adverse tax results which otherwise would occur under Code sections 72(p), 401(a) and 497 will not occur.

As stated above, certain plan sponsors will be entitled to use a model amendment to amend their plans. A financial institution which adopts the model amendment will need to file Form 8837, Notice of Adoption of Revenue Procedure Model Amendments. CWF will assist in the preparation and filing of this form for those financial institutions which have adopted its prototypes.

The IRS has prepared the following two model amendments.

Amendment I

(Note to Sponsor: The following model amendment may be used to amend plans to provide for the requirements of USERRA and 414(u) of the Code.)

"Notwithstanding any provision of this plan to the contrary, contributions, benefits and service credit with respect to qualified military service will be provided in accordance with section 414(u) of the Internal Revenue Code."

Amendment II

(Note to Sponsor: The following model amendment may be used to amend plans that provide loans to participants, if the sponsor chooses to suspend loan repayments during participants' periods of military service.)

"Loan repayments will be suspended under this plan as permitted under section 414(u)(4) of the Internal Revenue Code."

IRS Issues Proposed Regulation — Creates Relief for Plans Which Mistakenly Accept Nonqualifying Rollovers

In September of 1995, the IRS issued a final regulation which set forth new rules with respect to direct rollovers. The IRS adopted the rule that a qualified plan would not be disqualified if it accepted a direct rollover which did not really qualify for rollover treatment if, prior to accepting such rollover, the receiving plan reasonably concluded that the distribution was qualified. For example, a plan administrator would be found to have acted reasonably if the plan administrator of the distributing plan had provided a written statement that the IRS had issued a "recent" favorable determination or opinion letter from the IRS. The plan administrator was not required to ask for a copy of the plan document or the actual IRS letter.

The IRS has two goals in issuing the proposed regulation. First, the final regulation did not cover the old style rollover rules as authorized by Internal Revenue Code section 402. That is, no relief was granted if a qualified plan accepted an invalid rollover from another qualified plan or conduit IRA. Second, this proposed regulation expands and clarifies when relief would be granted to a qualified plan which accepts an invalid direct rollover.

The proposed regulation provides that a qualified plan will not suffer any adverse tax consequences even if it accepts an invalid rollover if the following two conditions are satisfied.

The first condition is that when accepting the amount from the employee as a rollover contribution, the plan administrator of the receiving plan must reasonably conclude that the contribution is a

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QP Amendment—*Continued from page 3*

valid contribution (i.e. qualifies to be rolled over). The second condition is that if the plan administrator of the receiving plan later determines that the accomplished rollover contribution was invalid, then the plan administrator must distribute to the employee the amount of the invalid rollover contribution plus any attributable earnings. This corrective distribution must take place within a reasonable time after determining that the rollover was invalid.

The IRS then furnishes some examples to illustrate what type of verification or documentation will show that the plan administrator acted reasonably in concluding that the rollover from the qualified plan or IRA would be valid.

The IRS again says that in a direct rollover situation a letter from the IRS is sufficient, as long as there are not any known facts which would contradict this conclusion.

The IRS then gives some illustrations for what would suffice in the situation where the funds were distributed to the employee or are coming from a conduit IRA. The IRS indicates the following approach — the employee wishing to make the rollover must certify that the rollover rules have been complied with, and then attach some documents that support this certification.

If an employee (versus a spouse beneficiary) receives a distribution from a qualified plan, and then decides he or she wishes to make a rollover, then he or she must certify to the best of his or her knowledge to the following: (1) that he or she is entitled to the distribution because of his or her status as a participant; (2) the distribution was not part of a series of periodic distributions; (3) the distribution was not received more than 60 days before the day of the rollover contribution; and (4) the entire amount of the rollover contribution would be taxable if it were not rolled over. To verify this certification, the plan administrator of the receiving plan should also receive a letter from the paying plan that it had received a favorable determination letter from the IRS and a copy of the section 402(f)/distribution notice which the plan had furnished the individual.

If the employee receives a distribution from a conduit IRA with the wish to make a rollover, then he or she must certify to the best of his or her knowledge to the following: (1) same four items as described in the paragraph above; (2) that no amount other than the distribution from a qualified plan has been contributed to the IRA and (3) that the distribution to the new qualified plan was not received more than 60 days after distribution from the IRA. As support of these certifications, in addition to the two statements as furnished from the original qualified plan, the new employee furnishes copies of IRA statements which confirm that the original 60-day requirement was met and that no additional contributions were made.

Summary

The IRS has tried to come up with partial relief for a qualified plan which would somehow accept an invalid rollover. The IRS will grant relief only if the plan administrator took substantial precautions to determine that the rollover was valid. The IRS examples indicate that a plan administrator must ask for substantial documentation in order to satisfy the IRS. In the case of a conduit rollover, the IRS will apparently require that the employee be able to verify that the first rollover was valid, as well as the rollover to be made from the IRA. The only qualified plans which may be willing to put up with those requirements will be 401(k) plans. PD

IRS to Substantially Revise its Administrative Policy Regarding Sanctions

Approximately five years ago, the IRS dramatically changed its administrative approach. The IRS devised programs to encourage plan sponsors to voluntarily correct errors in plan administration. The IRS indicated that a plan sponsor could expect the IRS to adopt a harsh approach if a plan sponsor knew of plan administration errors and did not voluntarily move to correct such errors under these IRS procedures. The IRS created a number of administrative programs. This article will discuss two of those programs which the IRS intends to change: the voluntary compliance resolution program (VCR), standardized voluntary compliance resolution program (SVP), and the Administrative Policy Regarding Sanctions (APRS).

The concept of the VCR program was: a plan sponsor which had violated various qualification requirements could regain qualified status by paying a fixed amount of money (i.e. a fine) and by correcting all such errors. This fine could vary from $500 to tens of thousands of dollars.

The concept of the initial APRS program was — some errors were so minimal and so infrequent that an employer should be able to correct them without having to enter the VCR program. That is, the employer could correct the mistakes and did not have to pay any user fee. But the APRS was not available if the IRS discovered the error upon an audit, no matter how insignificant the operational error. The IRS permitted an employer to use APRS only if there had been one minor operational error in a single year.

The IRS has decided to significantly expand the APRS program. The IRS appears ready to modify this program to allow more than one minor error per year. The IRS is even considering allowing a plan sponsor to use the APRS program to correct more serious errors as long as they are corrected by the end of the next plan year.

The APRS could also be used by an employer even if the IRS discovered the minor operational defects via an audit.

The APRS is an internal IRS program. Plan sponsors and plan administrators will be excited by this new IRS program. It is much more plan-sponsor friendly than past programs. PD