Plan Distributions

IRS Final Regulations Allow Defined Contribution Plans to Jettison Some Optional Forms of Payment

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New IRS regulations allow plans to make amendments that eliminate some benefit options previously offered. They also address voluntary direct transfers between plans to provide relief in the area of mergers and acquisitions, and they clarify the protections afforded in-kind distributions. We'll learn more about these new regulations here.

INTRODUCTION

On August 31, 2000, the Internal Revenue Service (IRS) issued final regulations under Section 411(d)(6) of the Internal Revenue Code (Code) that allow defined contribution plans to be amended to eliminate certain optional forms of benefit. The final regulations became effective September 6, 2000 and apply to plan amendments that are adopted and effective on or after that date.

The new final regulations also significantly liberalize the elective transfer provisions of the 1988 final regulations under Code Section 411(d)(6). In addition, the new rules clarify and modify the rules regarding the application of the protections of Code Section 411(d)(6) to a participant's right to receive benefit distributions in kind from defined contribution and defined benefit plans.

The new final regulations were published in the Federal Register on September 6, 2000. [65 FR 53901] The major provisions of the new final regulations under Code Section 411(d)(6) are described below.

PERMITTED AMENDMENTS TO ALTERNATIVE FORMS OF PAYMENT UNDER A DEFINED CONTRIBUTION PLAN

In general, the new final regulations significantly expand the permitted changes that may be made to alternative forms of payment under a defined contribution plan. The new rules generally provide that a defined contribution plan will not violate the requirements of Code Section 411(d)(6) merely because the plan is amended to eliminate or restrict a participant's ability to receive payment of his or her accrued benefit under a particular optional form of benefit if (after the plan amendment is effective with respect to the participant) the alternative forms of payment available to the participant include payment in a single-sum distribution form that is "otherwise identical" to the optional form of benefit that is being eliminated or restricted. The new final regulations include rules for determining whether a single-sum distribution is "otherwise identical" to an optional form of benefit that is being eliminated or restricted.

The new final regulations also include a provision protecting participants who will be taking distributions shortly after the plan is amended and who may have planned on the availability of the payment form that is being eliminated or restricted. Under this provision, a plan amendment that eliminates or restricts the participant's ability to receive a particular optional form of benefit cannot apply to any distribution that has an annuity starting date prior to the earlier of (1) the 90th day after the date the participant receiving the distribution has been furnished with a summary of material modifications (SMM) that describes the amendment and otherwise meets the applicable requirements of U.S. Department of Labor (DOL) regulations [DOL Reg § 2520.104b-3 (relating to SMMs for pension plans), or (2) the first day of the second plan year following the plan year in which the plan amendment is adopted.

For these purposes, a single-sum distribution form is "other-

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wise identical" to an optional form of distribution that is eliminated or restricted only if it is identical in all respects to the eliminated or restricted optional form of benefit (or would be identical except that it provides greater rights to the participant) except with respect to the timing of payments after commencement. The new final regulations provide, for example, that a single-sum distribution form is not "otherwise identical" to a specified installment form of benefit if the single-sum distribution form is not available for distribution on the date on which the installment form would have been available for commencement, is not available in the same medium of distribution as the installment form, or imposes any condition of eligibility that did not apply to the installment form. The new final regulations also clarify that an "otherwise identical" distribution form need not retain rights or features of the optional form of benefit that is eliminated or restricted to the extent that those rights or features would not be protected from elimination or restriction under Code Section 411(d)(6) or Treasury Regulations Section 1.411(d)-4. [Treas Reg § 1.411(d)-4, Q&A-2(e)(2)]

The following examples illustrate the application of these provisions of the new final regulations.

Example 1. Meredith is a participant in the Knox Novelties, Inc. Profit-Sharing Plan, a qualified profit-sharing plan with a calendar plan year that is invested in mutual funds. The distribution forms available to Meredith under the plan include a distribution of Meredith's vested account balance under the plan in the form of distribution of various annuity contract forms (including a single life annuity and a joint and survivor annuity). The annuity payments under the annuity contract forms begin as of the first day of the month following Meredith's termination of employment (or as of the first day of any subsequent month, subject to the requirements of Code Section 401(a)(9)). Meredith has not previously elected payment of benefits in the form of a life annuity, and the plan is not a direct or indirect transferee of any plan that is a defined benefit plan or a defined contribution plan that is subject to the minimum funding requirements of Code Section 412. The plan provides that distributions on the death of a participant are made in accordance with Code Section 401(a)(11)(B)(iii)(l).

On May 15, 2001, the plan is amended so that, after the amendment is effective, Meredith is no longer entitled to any distribution in the form of the distribution of an annuity contract. However, after the amendment is effective, Meredith is entitled to receive a single-sum cash distribution of her vested account balance under the plan payable as of the first day of the month following her termination of employment (or as of the first day of any subsequent month, subject to the minimum distribution requirements of Code Section 401(a)(9)). The amendment does not apply to Meredith if she elects to have annuity payments begin before the earlier of January 1, 2003 or 90 days after the date on which the plan administrator of the plan furnishes her with a summary that reflects the amendment and that satisfies the requirements of DOL Regulations Section 2520.104b-3. On December 14, 2001, the plan administrator of the plan furnishes Meredith with a summary plan description that reflects the amendment and that satisfies the requirements of those regulations. The plan does not violate the requirements of Code Section 411(d)(6) (or Code Section 401(a)(11)) merely because, as of March 14, 2002, the plan amendment has eliminated Meredith's option to receive a distribution in any of the various annuity contract forms previously available. [Treas Reg § 1.411(d)-4, Q&A-2(e)(3), Ex 1]

Example 2. Steve is a participant in the Connecticut Yankee Retirement Plan, a qualified profit-sharing plan to which Code Section 401(a)(11)(A) does not apply. Upon termination of employment, Steve is entitled to receive cash distributions from the plan, payable as of the first day of the month following his termination of employment (or as of the first day of any subsequent month, subject to the minimum distribution requirements of Code Section

401(a)(9)), in the form of a single-sum distribution, or in substantially equal monthly installment payments over either 5, 10, 15, or 20 years. On May 15, 2001, the plan is amended so that, after the amendment is effective, Steve is no longer entitled to receive a distribution in the form of substantially equal monthly installment payments over 5, 10, 15, or 20 years. However, after the amendment is effective, Steve continues to be entitled to receive cash distributions from the plan, payable as of the first day of the month following his termination of employment (or as of the first day of any subsequent month, subject to the minimum distribution requirements of Code Section 401(a)(9)), in the form of a single-sum distribution. The amendment does not apply to Steve if he elects to have annuity payments begin before January 1, 2002. On September 20, 2001, the plan administrator of the plan furnishes Steve with a SMM that reflects the amendment and that satisfies the requirements of DOL Regulations Section 2520.104b-3.

The plan does not violate the requirements of Code Section 411(d)(6) merely because, as of January 1, 2002, the plan amendment has eliminated Steve's option to receive a distribution in the form of substantially equal monthly installment payments over 5, 10, 15, or 20 years. [Treas Reg § 1.411(d)-4, Q&A-2(e)(3), Ex 2]

VOLUNTARY DIRECT TRANSFERS BETWEEN PLANS

The final regulations that the IRS issued in 1988 under Code Section 411(d)(6) permitted the elimination of optional forms of benefit in connection with transfers of benefits from one plan to another with a participant's consent (i.e., elective transfers). [Treas Reg § 1.411(d)-4, Q&A-3(b)] The 1988 final regulations permitted an elective transfer from one qualified plan to another only if the participant's benefit under the transferring plan was immediately distributable (i.e., a distributable event transfer). The "immediately distributable" requirement prevented elective transfers in connection with mergers and acquisitions involving 401(k) plans in cases where plan benefits were not distributable because Code Section 401(k)(10) (relating to 401(k) plan distributions upon plan termination or the disposition of assets or subsidiaries) did not apply. Allowing elective transfers from an employee's former employer's 401(k) plan to his new employer's 401(k) plan under these circumstances would allow employees to keep all of their qualified plan benefits under one plan, which would be particularly important in cases where the new employer chooses not to maintain the former employee's plan.

The new final regulations retain and modify previously applicable Code Section 411(d)(6) relief for distributable event transfers and add new Code Section 411(d)(6) relief for elective transfers in connection with certain corporate mergers and acquisitions or changes in a participant's employment status (i.e., transaction or employment change transfers). As a result, Code Section 411(d)(6) relief applies in each of the following cases:

- *Direct Rollover.* Existing rules provide that if a direct rollover is made from one qualified retirement plan to another, as described under Code Section 401(a)(31), the receiving plan is not required by Code Section 411(d)(6) to offer the same optional forms of benefit as the sending plan offered. [Treas Reg § 1.401(a)(31)-1, Q&A-14]
- *Distributable Event Transfer.* In any case in which a participant is entitled to a distribution from either a defined benefit or defined contribution plan, but he or she is not eligible to receive an immediate distribution of his or her entire vested accrued benefit in a single-sum distribution that can be entirely rolled over, the new final regulations provide Code Section 411(d)(6) relief for a voluntary transfer.
- *Transaction or Employment Change Transfer.* Even if a participant is not entitled to a distribution to which the distributable event transfer rules apply, the new final regulations allow a voluntary transfer from a defined contribution plan to another defined contribution plan of the same type if the transfer occurs in connection with a corporate merger or acquisition or change in the participant's employment status. [Treas Reg § 1.411(d)-4, Q&A-3(b)]

RULES REGARDING IN-KIND DISTRIBUTIONS

The new final regulations clarify and modify the rules regarding the application of the protections of Code Section 411(d)(6)(B) to a right to receive benefit distributions in kind from defined contribution and defined benefit plans. Provisions for distribution in kind are sometimes found, for example, in plans invested in annuity contracts or in marketable mutual funds. The right to a particular form of investment is not a protected optional form of benefit. However, the investments made by a plan generally are subject to fiduciary requirements, including the prudence requirement of Section 404(a)(1)(B) of ERISA. The 1988 final regulations under Code Section 411(d)(6) state that the right to a medium of distribution such as cash or in-kind payments is an optional form of benefit to which under Code Section 411(d)(6) applies.

The new final regulations under Code Section 411(d)(6) clarify that a participant's right to receive a particular benefit in the form of cash payments from either a defined benefit or defined contribution plan and a participant's right to receive that benefit in the form of the distribution of an annuity contract that provides for cash payments that are otherwise identical in all respects to those cash payments from the plan are not separate optional forms of benefit. Therefore, for example, if a plan includes an optional form of benefit under which benefits are distributed in the medium of an annuity contract that provides for cash payments, that optional form of benefit may be modified by a plan amendment that substitutes cash payments from the plan for the distribution of the annuity contract, where those cash payments from the plan are identical to the cash payments payable from the annuity contract in all respects except for the source of the payments. Of course, a defined contribution plan that continues to offer a life annuity form of distribution must purchase an annuity contact from an insurance carrier in order to provide that optional form (and the plan may either distribute that contract to the participant or hold the contract as a plan asset from which it makes the payments for the participant).

The new final regulations permit a defined contribution plan to be amended to replace the ability to receive a distribution in the form of *marketable securities* (other than employer securities) with the ability to receive a distribution in the form of cash. Thus, the right to distributions from a defined contribution plan in the form of cash, employer securities, or other property that is not marketable securities is generally protected. The protection for employer securities reflects the potential value of the special tax treatment provided to net unrealized appreciation (NUA) on employer securities under Code Section 402(e)(4). The protection for assets that are not marketable securities reflect the possibility that a participant may assign a higher value to such assets than does the plan and that the participant might not have the ability to acquire the asset after receiving a cash distribution.

The following examples illustrate the application of these new rules.

Example 1. Knox Novelties, Inc. maintains a profit-sharing plan under which participants may direct the investment of their accounts. One investment option available to participants is a fund invested in common stock of the employer. The plan provides that the participant has the right to a distribution in the form of cash upon termination of employment. In addition, the plan provides that, to the extent a participant's account is invested in the employer stock fund, the participant may receive an in-kind distribution of employer stock upon termination of employment. On October 18, 2000, the plan is amended, effective on January 1, 2001, to remove the fund invested in employer common stock as an investment option under the plan and to provide for the stock held in the fund to be sold. The amendment permits participants to elect how the sale proceeds are to be reallocated among the remaining investment options, and provides for amounts not so reallocated as of January 1, 2001 to be allocated to a specified investment option.

The plan does not fail to satisfy Code Section 411(d)(6) solely on account of the plan amendment relating to the elimination of the employer stock investment option, which is not a Code Section 411(d)(6) protected benefit. Moreover, because the plan did not provide for distribution of employer securities except to the extent participants' accounts were invested in the employer stock fund, the plan is not required operationally to offer distributions of employer securities following the amendment. In addition, the plan would not fail to satisfy Code

Section 411(d)(6) on account of a further plan amendment, effective after the plan has ceased to provide for an employer stock fund investment option (and participants' accounts have ceased to be invested in employer securities), to eliminate the right to a distribution in the form of employer stock. [Treas Reg § 1.411(d)-4, Q&A-2(b)(2)(iii)(D), Ex 1]

Example 2. Knox Novelties, Inc. maintains a profit-sharing plan under which a participant, upon termination of employment, may elect to receive benefits in a single-sum distribution either in cash or in kind. The plan's investments are limited to a fund invested in employer stock, a fund invested in XYZ mutual funds (which are marketable securities), and a fund invested in shares of PQR limited partnership (which are not marketable securities).

The following alternative plan amendments would not cause the plan to fail to satisfy Code Section 411(d)(6):

- **(i)** A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership.
- **(ii)** A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership, and that also provides that only participants with employer stock allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of employer stock, and that only participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of shares of PQR limited partnership. To comply with the plan amendment, the plan administrator retains a list of participants with employer stock allocated to their accounts as of the effective date of the amendment, and a list of participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment.
- **(iii)** A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership to the extent that those assets are allocated to the participant's account at the time of the distribution.
- **(iv)** A plan amendment that limits non-cash distributions to a participant on termination of employment to a distribution of employer stock and shares of PQR limited partnership, and that provides that only participants with employer stock allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of employer stock, and that only participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment have the right to distributions in the form of shares of PQR limited partnership, and that further provides that the distribution of that stock or those shares is available only to the extent that those assets are allocated to those participants' accounts at the time of the distribution. To comply with the plan amendment, the plan administrator retains a list of participants with employer stock allocated to their accounts as of the effective date of the amendment and a list of participants with shares of PQR limited partnership allocated to their accounts as of the effective date of the amendment. [Treas Reg § 1.411(d)-4, Q&A-2(b)(2)(iii)(D), Ex 2]

Example 3. Knox Novelties, Inc. maintains a stock bonus plan under which a participant, upon termination of employment, may elect to receive benefits in a single-sum distribution in employer stock. This is the only plan maintained by the employer under which distributions in employer stock are available. The employer decides to terminate the stock bonus plan.

If the plan makes available a single-sum distribution in employer stock on plan termination, the plan will not fail to satisfy Code Section 411(d)(6) solely because the optional form of benefit providing a single-sum distribution in employer stock on termination of employment is modified to provide that such distribution is available only in cash. [Treas Reg § 1.411(d)-4, Q&A-2(b)(2)(iii)(D), Ex 3]

CONCLUSION

The new final Treasury regulations under Code Section 411(d)(6) should simplify plan administration significantly. In the preamble to the final regulations, the IRS and Treasury recognized that the accumulation of a variety of payment choices under a plan could increase the cost and complexity of plan operations. The IRS and Treasury also recognized that, in recent years, it has become easier for individuals to replicate the various payment choices available from qualified plans through other means, particularly IRAs to which qualified plan distributions have been directly rolled over. Finally, the IRS and Treasury have recognized that the vast majority of participants in defined contribution plans prefer single-sum distributions over other available distribution forms. The new final regulations' sensitivity to plans' administrative burdens, to the realities of the financial marketplace, and to participants' preferences is refreshing indeed.