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IRS RELENTS - DEFINED CONTRIBUTION PLANS CAN NOW ELIMINATE OPTIONAL FORMS OF BENEFITS

The IRS issued new regulations on August 31, 2000, that will make it possible for sponsors of many qualified plans to modify their plans to eliminate all benefit forms other than cash lump-sums.

Defined-contribution plans -- such as profit-sharing plans, ESOPs and 401(k) plans -- normally allow participants to receive their benefits in the form of a lump sum. Some defined-contribution ("DC") plans also offer one or more forms of installment or annuity benefits.

There are many reasons why the sponsor of a DC plan might have decided to offer installment or annuity forms of benefits. In the days before tax-free rollovers were possible, for example, plans allowed payment over time as the only way to avoid immediate tax on the full benefit. Also, many options were adopted inadvertently when adopting a prototype plan, or options might have had to be retained when plans were merged after a corporate merger or acquisition.

Whatever may have been the reason for including optional forms, many DC plan sponsors now regret having them in their plans. Almost all participants who have the right to elect a lump-sum benefit do so, either to enjoy the money or to make a tax-deferred rollover to an IRA (of which they are in complete control) or another qualified plan. For many plan sponsors, therefore, the installment and annuity benefit options just add to the plan's complexity and expense without providing any appreciable benefit to the employees.

Unfortunately, until very recently sponsors of qualified plans were unable to eliminate those optional forms of benefit. The IRS rigidly applied Section 411(d)(6) of the Internal Revenue Code, on the theory that the optional forms were part of a participant's "accrued benefit" that cannot be taken away.

Fortunately, the IRS finally has recognized that it will be beneficial to allow employers to amend most kinds of DC plans to eliminate all forms of benefit other than the lump-sum benefit. In its regulation adopted August 31, 2000, the IRS allows such amendments as to all optional forms, whether the alternatives are installments or annuity benefits. This will be a great opportunity for employers to reduce the complexity of the plan documents and make the administration of the plans much easier. There are, as usual, a few exceptions and special rules:

Although the new rules apply to almost all qualified profit-sharing plans, stock bonus plans, and 401(k) plans, the new rules have some limits on their scope: they do not apply to defined-benefit pension plans; they do not relieve money purchase pension plans (or any successor to a money-purchase pension plan) of the requirement to offer qualified joint and survivor annuities; and they do not change the rule that immediate payment cannot be compelled from any plan if a person leaves before age 62 with a vested benefit of more than $5,000.

To implement the new rule, an employer must amend its plan to eliminate the optional forms, and must communicate the changes to the participants by means of a new Summary Plan Description (or Summary of Material Modifications) that properly informs the participants of the amendment. The effective date of the amendment can be as early as 90 days after those steps have been taken, but the amendment can not affect a benefit payable beginning before the effective date.

The IRS in these new regulations also announced that in many circumstances a plan that offers benefits in a form other than cash (such as employer securities) can be modified to eliminate the payment of benefits other than in cash.

Finally, the new regulations also allow plan-to-plan transfer of accrued benefits in many situations where such transfers had not previously been allowed. The combination of these new rules and the ability to eliminate optional forms of benefits will enable many employers to eliminate multiple plans that might have resulted from mergers and acquisitions.

Remember that these legal principles may change and vary widely in their application to specific factual circumstances. You should consult with counsel about your individual circumstances. For further information regarding these issues, contact:

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