

# KEEPING THE QUALIFIED PENSION PLAN QUALIFIED AND RECOGNIZING THE TAX EFFECTS OF DISQUALIFICATION

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## I. INTRODUCTION

Pension plans,<sup>1</sup> which afford taxpayers special tax considerations,<sup>2</sup> may be established for the benefit of eligible employees. The Internal Revenue Code provides the tax rules governing such plans.<sup>3</sup> These rules have recently undergone numerous revisions, including those contained in the Employee Retirement Income Security Act of 1974 (ERISA).<sup>4</sup>

There are two broad classifications of pension plans—qualified and nonqualified. A qualified plan meets all the requirements, both in form and operation, of section 401 whereas a nonqualified plan does not.<sup>5</sup>

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1. As used in this article, the phrase "pension plan" or "plan" means a program, plan, or fund established by a corporation for the benefit of its eligible employees, including all profit-sharing, money-purchase pension, target benefit, and defined benefit plans. See 29 U.S.C. § 1002 (2), (34), (35), and (36) (Supp. V 1975). This article is not specifically intended to treat unqualified plans, Keogh plans, individual retirement accounts, see I.R.C. § 408, or annuities, see I.R.C. § 403, although many subjects discussed herein are applicable to these plans.

2. The special tax considerations afforded qualified plans include current employer deductions, deferral of income for employees, and exemption of the income of the plan's trust. For a complete discussion of the general tax benefits applicable to qualified plans and the historical development of these enactments, see 4A J. MERTENS, THE LAW OF FEDERAL INCOME TAXATION § 25B.01-.64 (1972 ed.).

3. All references in this article are to the Internal Revenue Code of 1954, as amended, unless noted otherwise. The general, non-tax rules governing pension plans are codified in 29 U.S.C. §§ 1001-1381 (Supp. V 1975).

4. Pub. L. No. 93-406, 88 Stat. 829 (1974) (codified in scattered sections of 5, 18, 26, 29, 31, & 42 U.S.C.). All references to ERISA made in this article are designated "Act § —."

5. Cf. I.R.C. § 401 (sets forth both affirmative qualification requirements and characteristics which, unless contained in the plan, will be cause for nonqualification).

There are approximately 500,000<sup>6</sup> qualified pension plans in the United States, and all must be amended to comply with ERISA.<sup>7</sup> As of November 1976, the Internal Revenue Service (IRS) had received approximately 115,000 requests for determination letters.<sup>8</sup> Upon completion of this massive qualification process,<sup>9</sup> attention in the pension plan area will shift to the actual operation of the plan under ERISA. This article discusses some of the anticipated problems in this emerging area of the law, and considers the tax effects that result from a plan's disqualification.

## II. SELF-REVIEW AUDIT PERIOD—RESPONSIBILITY, DUTIES, AND PRECAUTIONS

A plan's qualified status, regardless of whether the IRS has issued a determination letter,<sup>10</sup> is measured under the then applicable pension plan law. A change in a relevant statute, regulation, or revenue ruling can affect the qualified status of a plan. To ensure conformity with the applicable law, therefore, a plan should undergo an annual "self-re-

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6. Speech by I. Goodman, November 12, 1976, *reprinted in* PENS. PLAN GUIDE (CCH) ¶ 25,157.

7. *See generally* Act § 1017. As to nonqualified pension plans subject to ERISA, see Act § 211. Some plans have been terminated as a result of ERISA's passage. The IRS has established a "hot line" to dissuade plan terminations. *See* I.R. 1895 [1977] FED. TAXES (P-H) ¶55, 947.

8. *See* speech by I. Goodman, *supra* note 6. Upon a taxpayer's request, the I.R.S., acting under authority, granted in Rev. Proc. 72-3, 1972-1 C.B. 698, *updated by* I.R.-1683, [1976] FED. TAXES (P-H) ¶ 55,679, *and* I.R.-1817, [1977] FED. TAXES (P-H) ¶ 55,538, and Announcement 76-130, 1976—43 I.R.B. 28, will issue a determination letter with respect to the current qualified status of a plan. *See generally* 4A, J.MERTENS, *supra* note 2, § 25B.20-21.

9. An initial ERISA letter of determination, if obtained under the special reliance procedure (SRP), is valid only until December 31, 1977. Many plans will thus have to be reamended to comply with regulations and rulings issued since the plan obtained its first ERISA determination letter. For plans in this circumstance, however, an additional year for compliance is allowed. I.R. 1675, [1976] FED. TAXES (P-H) ¶ 55,595. SRP is a unique procedure, approved by the IRS and Department of Labor to facilitate the processing of qualification letter requests under ERISA, which enabled employers to adopt a plan that met specified criteria without concern for subsequently issued guidelines, rulings, or regulations. The full text of the SRP is set forth in T.I.R. 1416, [1975] FED. TAXES (P-H) ¶ 55,789, *modified by* I.R. 1616, [1976] Fed. Taxes (P-H) ¶ 55,250, *republished as*, Rev. Proc. 76-31, 1976-2 C.B. 649. As of this date, the SRP is only applicable to plans that submitted qualification requests on or before December 31, 1976. Given the number of extensions to the remedial amendment period, however, *see* note 25 *infra*, the SRP is of little continuing importance.

10. A plan can be qualified by meeting the requirements of I.R.C. § 401(a). There is no requirement that a determination letter be obtained.

view.” With the advent of ERISA and its continuing reformulation, this self-review should focus on both the form and the operation of the plan.<sup>11</sup> An annual self-review<sup>12</sup> is further suggested because it coincides with a basic principle of pension plan law; specifically, that a plan’s qualified status will be determined on a year-to-year basis.<sup>13</sup>

### A. *Form of the Plan*

If the plan’s form must be amended to comply with the current law, those changes, whether substantial or minor, must be made in a timely fashion. The plan amendment guidelines are set forth in section 401(b) and its regulations.<sup>14</sup>

Prior to ERISA, a plan could be amended at any time during the plan year for that year. With respect to certain items, pre-ERISA section 401(b) also provided that the plan could be amended within seventy-five days after the close of the initial plan year retroactively for that year.<sup>15</sup>

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11. Treas. Reg. § 1.401-1(b)(3) (1956). The IRS’s current qualification letters contain the following statement: “Continued qualification of the Plan will depend on its effect in operation under its present form . . . . The status of the Plan in operation will be reviewed periodically.” Form 794.

12. An annual review should suffice for most plans; approximately 80% have less than 10 participants, and the number of transactions and events during a year can be quickly ascertained, summarized, and analyzed. Of course, the larger the plan, the more time it will take to review it properly.

13. See *Greenwald v. Commissioner*, 366 F.2d 538, 541 (2d Cir. 1966); Treas. Reg. § 1.401 (c) (1956); Rev. Rul. 71-153, 1971-1 C.B. 127; Rev. Rul. 63-10, 1963-1 C.B. 90.

14. Technically, as discussed in notes 20-31 *infra* and accompanying text, I.R.C. § 401(b) applies only to “disqualifying provisions.” With regard to non-disqualifying provisions, the generally accepted rule is that the plan amendment must be executed and made effective within the plan year to which the amendment is to apply. In *Aero Rental v. Commissioner*, 64 T.C. 331 (1975), however, the Tax Court held that pre-ERISA I.R.C. § 401(b) was a “safe harbor” provision and allowed retroactive form amendments to a plan to be made at a time beyond that afforded by the statute. 64 T.C. at 341. Nevertheless, because *Aero Rental* applied only to an initial qualification request, its application to all form amendments is uncertain. *But see Mendenhall Corp. v. Commissioner*, 68 T.C. —, [1977] TAX. CT. REP. (CCH) Dec. 34,556, discussed at notes 34-35 *infra* and accompanying text.

15. Prior to ERISA, I.R.C. § 401(b) read as follows:

CERTAIN RETROACTIVE CHANGES IN PLAN. A stock bonus, pension, profit-sharing or annuity plan shall be considered as satisfying the requirements of paragraphs (3), (4), (5) and (6) of subsection (a) for the period beginning with the date on which it was put into effect and ending on the 15th day of the third month following the close of the taxable year of the employer in which the plan was put in effect, if all provisions of the plans which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes with respect to the whole of such period.

The ability to use this section for certain retroactive changes was limited to initial

ERISA had a significant impact on section 401(b) because it extended the time during which amendments to a plan's form may be made for a given plan year.<sup>16</sup> Section 401(b) now provides:

**CERTAIN RETROACTIVE CHANGES IN PLAN**—A stock bonus, pension, profit-sharing, or annuity plan shall be considered as satisfying the requirements of subsection (a) for the period beginning with the date on which it was put into effect, or for the period beginning with the earlier of the date on which there was adopted or put into effect any amendment which caused the plan to fail to satisfy such requirements, and ending with the time prescribed by law for filing the return of the employer for his taxable year in which such plan or amendment was adopted (including extensions thereof) or such later time as the Secretary may designate, if all provisions of the plan which are necessary to satisfy such requirements are in effect by the end of such period and have been made effective for all purposes for the whole of such period.

The Secretary of the Treasury has issued extensive regulations which amplify this statute. It is important to note that the regulations are limited to the amendment of "disqualifying provisions."<sup>17</sup> This refers to "[a] provision of a new plan, the absence of a provision from a new plan, or an amendment to an existing plan, which causes such plan to fail to satisfy" the Code's qualification requirements as of the date such plan or amendment is first made effective;<sup>18</sup> or, a provision which disqualifies the plan because of a change in the qualification requirements effected by ERISA.<sup>19</sup> Although subject to certain limitations,<sup>20</sup> current section

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qualifications and to subparagraphs (3)-(6), inclusive, of I.R.C. § 401(a) which then dealt with coverage, discrimination-in-operation, integration, and the four quarters test, respectively. *Cf. Aero Rental v. Commissioner*, 64 T.C. 331 (1975) (taxpayer successfully argues that I.R.C. § 401(b) permits retroactive plan form amendments), discussed in notes 32-33 *infra* and accompanying text.

16. Under ERISA each plan is required to specify a definite plan year. *See Act* § 3(39). In most cases, the fiscal period of a plan will coincide with the fiscal year of the sponsoring corporate employer(s). *See Rev. Proc. 1977-44, —I.R.B.—*.

17. *Treas. Reg. § 1.401(b)-1(b)* (1976).

18. *Treas. Reg. § 1.401(b)-1(b) (1)* (1976).

19. *Treas. Reg. § 1.401(b)-1(b) (2)* (1976). For this purpose, the definition of disqualifying provision includes the absence from a plan of a provision required by any changes effected by ERISA if the plan was in effect on the date such change became effective with respect to such plan.

20. *Treas. Reg. § 1.401(b)-1(a)* (1976), provides two limitations on the availability of retroactive plan amendments. The first general rule provides, in its entirety:

Under some facts and circumstances, it may not be possible to amend a plan retroactively so that all provisions of the plan which are necessary to satisfy the

401(b) and its regulations generally provide greater latitude for retroactive amendments to the form of a plan than was permitted under pre-ERISA law.

Section 401(b) specifies that a disqualifying provision may be corrected retroactively on or before the last day in the "remedial amendment period."<sup>21</sup> In fact, all such provisions are remedied effective as of the date the amendments should have been made.<sup>22</sup> The remedial amendment period begins (i) in the case of a new plan, on the date the plan is put into effect; (ii) in the case of an amendment to an existing plan, on the date the plan amendment is adopted or put into effect, whichever is earlier; or (iii) in the case of an amendment to an existing plan initiated because of ERISA, on the date ERISA became effective with respect to that plan.<sup>23</sup> The regulation specifies when the remedial amendment period ends.<sup>24</sup> In the case of a plan maintained by one employer, the remedial amendment period ends with the latest of (a) the time prescribed by law, including extensions thereof, for the filing of the income tax return of the employer for the employer's taxable year in which falls the latest of (i) the date the remedial amendment period begins, or (ii) the date the amendment is adopted, or (iii) the date the amendment is made effective, or (b) the last day of the plan year within which falls the latest of (i) the date the remedial amendment period begins, or (ii) the date the amendment is adopted, or (iii) the date the amendment is made effective.<sup>25</sup> The

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requirements of section 401(a) are *in fact* made effective for the whole remedial amendment period. If it is not possible, the requirements of this section will not be satisfied even if the employer adopts a retroactive plan amendment which, *in form*, appears to satisfy such requirements. (emphasis added)

The second caveat is as follows: "Section 401(b) does not permit a plan to be made retroactively effective, for qualification purposes, for a taxable year prior to the taxable year of the employer in which the Plan was adopted by such employer." The first rule technically prohibits the use of I.R.C. § 401(b) plan amendments to correct operational defects. *See Forsyth Emergency Services, P.A. v. Commissioner*, 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,627; *Ludden v. Commissioner*, 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610 n.7. The second caveat prohibits the use of I.R.C. § 401(b) to implement a plan retroactively for a year prior to that in which it has been adopted.

21. *See* Treas. Reg. § 1.401(b)-1(c) (1976).

22. ERISA had many effective dates. For example, most of ERISA's substantive pension plan provisions, contained in Titles I and II of the Act, became effective with respect to plans in existence on January 1, 1974, as of the first day of the first plan year commencing after December 31, 1975. *See* Act §§ 211(b), 1017(b).

23. *See* Treas. Reg. § 1.401(b)-1(c)(1) (1976).

24. *See* Treas. Reg. § 1.401(b)-1(c)(2) (1976).

25. This general deadline for the end of the remedial amendment period was also extended by Treas. Reg. § 1.401(b)-1(c)(2)(iv) (1976) to December 31, 1976. On September 13, 1977, the final date was again extended, to December 31, 1977. I.R. 1883, [1977] FED. TAXES (P-H) ¶ 55,875.

plan may seek to extend the remedial amendment period by making a timely request for a determination letter.<sup>26</sup> In this circumstance, the remedial amendment period is generally extended until ninety-one days after the IRS makes its final determination, or until the plan timely files a petition with the United States Tax Court for a declaratory judgment.<sup>27</sup> In addition, the Secretary has granted the Commissioner extensive discretionary authority to extend the remedial amendment period.<sup>28</sup>

Still another consideration arises when the IRS issues a revenue ruling that affects a plan. Although a revenue ruling is an official, published IRS interpretation of a point of law, it does not have the effect of law.<sup>29</sup> Nevertheless, under pre-ERISA law<sup>30</sup> and ERISA practice,<sup>31</sup> the IRS

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26. See Treas. Reg. § 1.401(b)-1(d)(3) (1976).

27. *Id.*

28. See Treas. Reg. § 1.401(b)-1(e) (1976). Additional information concerning the application of the discretionary extension provisions as outlined by the Commissioner can be found in a publication to regional commissioners, *republished in PENS. PLAN GUIDE (CCH) ¶ 23,205.*

29. See 9 J. MERTENS, *supra* note 2, § 49.87(b).

30. In Rev. Proc. 72-6, 1972-1 C.B. 710, § 5.04, the IRS provided that the publication of a revenue ruling will not adversely affect the qualification of an individually designed plan if: (1) the plan was the subject of a favorable determination letter and the request for the letter contained no misstatement or omission of material facts, (2) the facts subsequently developed are not materially different from the facts on which the determination letter was based, (3) there has been no change in the applicable law, and (4) the employer that established the plan acted in good faith in reliance on the determination letter. The revenue procedure then states that "all such plans must be amended to comply with the published Revenue Ruling for subsequent years" and that "[t]he conforming amendment must be adopted before the end of the first taxable year that begins after the Revenue Ruling is published and must be effective, for all purposes, not later than the first day of the taxable year beginning after the Revenue Ruling is published." The same revenue procedure, § 5.05, provides similar rules for master or prototype plans. If these four tests are not met, the revenue ruling is effective immediately. Therefore, a plan should promptly be brought into compliance with a revenue ruling.

It should be noted that the revenue procedure refers to *taxable year*, which presumably refers to that of the employer, not of the plan, and which may present a timing problem if the employer(s) are on a fiscal year basis different from that of the plan. Additionally, because of the time such a ruling must be made effective—the first day of the next "taxable year"—a plan may actually have more time to comply with a newly issued revenue ruling than with other "disqualifying provisions" under Treas. Reg. § 1.401(b)-1 (1976). Because of the special nature of revenue rulings, however, this distinction makes sense. See note 29 *supra* and accompanying text.

A recent declaration by the Tax Court noted that "a taxpayer must keep informed about subsequent published rulings of the IRS which may affect his private (determination) ruling." *Wisconsin Nipple Fabricating Corp. v. Commissioner*, 67 T.C. 490, 497-98 (1976).

31. The following language is in IRS Form 794 (revised November 1976), which is attached to each ERISA qualification letter: "A Revenue Ruling can also adversely affect a favorable determination letter but only for years after the Ruling is issued. However, all

requires that a plan be amended to comply with an applicable revenue ruling as of the first day of the plan year commencing after the ruling was issued.

If changes in the law create the need to amend the form of a plan, and the required amendment is not made within the statutorily prescribed time, some courts have, in certain other limited circumstances, permitted otherwise untimely form amendments. In *Aero Rental v. Commissioner*,<sup>32</sup> the Tax Court permitted qualifying form amendments to be made well after the period allowed by statute and regulation. The retroactive form amendments did not affect the actual operation of the plan in issue. Moreover, the plan sought a determination letter within a relatively short time.<sup>33</sup> The importance of a prompt request for a determination letter was vividly apparent in *Mendenhall Corp. v. Commissioner*.<sup>34</sup> The Tax Court, in *Mendenhall*, held that form defects resulting from the omission of plan language that was required for life insurance limitations, non-reversion of corpus, full vesting on termination, and annual valuations, could not be retroactively cured under the *Aero Rental* doctrine because the taxpayer delayed more than three years before requesting a determination letter. It should be noted, however, that these cases involved initial qualification requests by pre-ERISA plans. It is not yet known whether the courts will permit retroactive qualifying form amendments to cure initial or subsequent qualification form defects that have not affected the operation of the plan.<sup>35</sup>

## B. Operation of the Plan

The second, and perhaps more critical aspect of the self-review process, involves a close scrutiny of the manner in which the plan is actually operated. The initial consideration is whether the plan is operated in accordance with its actual terms. If the plan's form complies with the

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plans must be amended to comply with relevant Rulings. The amendment must be effective not later than the first day of the first taxable year after the Ruling is published." Form 794.

32. 64 T.C. 331 (1975).

33. In *Community Servs., Inc. v. United States*, 422 F.2d 1353 (Ct. Cl. 1970), the plan requested a determination letter within two years after the amendment was adopted, and the court permitted the retroactive cure. Nevertheless, after the ERISA amendment to § 401(b), and *Aero Rental*, this two year period may not provide adequate protection. The Tax Court, in *Aero Rental*, was critical of the plan's adoption in the last month of the year and the plan's six month delay in requesting IRS approval. Otherwise, *Community Services* reaches the same result, and reflects *Aero Rental's* permissive philosophy.

34. 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,556.

35. *Aero* should not be broadly read to permit retroactive operational cures.

qualification requirements, the operation of that plan in accordance with its terms will avoid such patent operational problems as timely enrollment of participants, and the mechanical application of a benefit formula or vesting schedule.<sup>36</sup>

(i) *Minor Non-Discriminatory Variations*

A question that arises in this context is whether minor, non-discriminatory, operational, or administrative variations<sup>37</sup> from the actual terms of a plan will adversely affect the plan's qualified status. By definition, these variations do not relate to the qualification requirements contained in section 401(a), and thus a negative, although qualified, response is possible. In *Time Oil Co. v. Commissioner*,<sup>38</sup> the Ninth Circuit held that a plan's failure to pay contributions in cash,<sup>39</sup> keep records for two years, or pay participants their due benefits, did not disqualify the plan. The court held that the appropriate test was whether plan benefits were prejudiced or the employer's indirect benefits were increased.<sup>40</sup> Thus, although the dollar amount may be large, where the shift in advantage to employer or employee is not substantial and the variation is de minimis, substance rather than form should be the guide.<sup>41</sup> The court, however, urged caution:

At this point a caveat should be issued. This court has not reached the point herein of what should be held if the commissioner after discovering variations in form though not of substance should demand literal compliance in futuro with the approved plan and should

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36. See, e.g., *Myron v. United States*, 550 F.2d 1145 (9th Cir. 1977); *Ludden v. Commissioner*, 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610. See also I.R.C. § 401(a)(1).

37. This article separates "minor" and "major" operational errors. In practice, however, these distinctions are not always clear cut, although the critical definitional distinction is whether discrimination in operation, see I.R.C. § 401(a)(4), results from the particular variation or error. Generally, in practice, disqualification will not result from minor, nondiscriminatory errors. A "minor" variation will not relate to the qualification requirements of I.R.C. § 401.

38. 258 F.2d 237 (9th Cir. 1958).

39. The holding in *Time Oil* that corporate promissory notes can constitute deductible payments to qualified plans would probably be reversed by the Supreme Court. See *Williams v. Commissioner*, 429 U.S. 569 (1977).

40. 258 F.2d at 238. With respect to a determination of whether a plan is operated for the exclusive benefit of the eligible employees (I.R.C. § 401(a)(2)), Treas. Reg. § 1.401-1(b)(3) (1956) specifically provides that "[a]ll of the surrounding and attendant circumstances and details of the plan" can be considered, and thus supports the position advanced in *Time Oil*. See also notes 81-86 *infra* and accompanying text.

41. 258 F.2d at 238.

fail to get it. A court might grant him the prerogative of disallowing the deductions after such a warning. He is to be commended for insisting that taxpayers conform to the plan they established with his approval, but the interest of employees is also to be considered. Here while hard justice might befit Time Oil Company's officers, yet prospective consequences of injury to the employees from the commissioner's position here are quite possible as contrasted with the lack of injury shown to them in the shortcomings of the errant taxpayer.<sup>42</sup>

During the self-review process, therefore, uncovered "minor" errors should be promptly corrected, to avoid the Commissioner's "warnings."<sup>43</sup> This approach is reinforced by recognizing that the ultimate impact of a "minor" variation may be unknown at the time it occurs. In a later audit, an examining IRS agent may assert that the outcome of such variations were "foreseeable" and had become "major," or discriminatory, and thus necessitated the plan's disqualification.

#### (ii) *Bookkeeping-Administrative Errors*

During a plan's administration, mathematical, bookkeeping, or administrative errors can, and will be, made which may result in discrimination-in-operation or some other major operational problem. For example, a participant's eligibility,<sup>44</sup> vesting,<sup>45</sup> benefits,<sup>46</sup> or payments<sup>47</sup> could

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42. 258 F.2d at 239.

43. The *Time Oil* court's warning anticipated two recent Tax Court cases, see notes 48-52 *infra* and accompanying text, although the Tax Court's position is much stricter than the *Time Oil* philosophy. More importantly, a dangerous problem can arise if the terms of a plan are ambiguous or silent as to a particular operational problem, event, or fact. The solution is to amend the plan promptly (or seek an appropriate administrative determination) to clarify, address, or cure the specific situation. If the problem is not so addressed, problems can arise on audit.

44. A plan may have an eligibility period of six months, but may be operated on a year's eligibility basis. A possible ERISA problem may be the misapplication of the dual or multiple entry date requirements. *Pittman Constr. Co. v. United States*, 436 F.Supp. 1215 (E.D. La. 1977).

45. Assume that a pre-ERISA plan provided for vesting based upon "years of participation" in the plan, and that the plan is amended to provide for vesting based on "years of service" to comply with ERISA. It is possible that the plan may nevertheless be administered on a "participation" basis. Another likely example of the misapplication of a plan's vesting schedule is crediting some, but not all, participants who terminated employment during a plan year and had 1000 or more hours of service with a year of service. A third example is the failure to apply properly the hour-of-service standard.

46. Assume that a defined benefit plan provided a unit benefit formula of 1/2 of 1% of compensation for each year of service prior to the adoption of the plan and 1% per year commencing with the adoption of the plan, and that the plan was adopted in 1960. The

all be affected by incorrect or inaccurate administration. Unfortunately, these errors, which by definition occur inadvertently, are prevalent and frequently repetitive; this serves to compound a plan's potential for serious, discriminatory operational defects. They are most common in smaller plans, which cannot afford the constant attention of competent, professional administrators.

A recent trilogy of Tax Court cases is particularly relevant to the resolution of the "bookkeeping" error issue. The taxpayer in *Quality Brands, Inc. v. Commissioner*,<sup>48</sup> argued that the alleged discrimination-in-operation was the result of "bookkeeping mistakes" in the allocation of forfeitures, which could be corrected by retroactive mathematical adjustments without prejudice to any party. The Tax Court did not reach the merits of the taxpayer's argument because it held that the discrimination did not result from an "error." The court concluded that the trustee's interpretation of the formula for allocating forfeitures resulted in the plan's being discriminatory-in-operation.<sup>49</sup>

The Tax Court, in an opinion by Judge Scott, addressed this issue again in *Ludden v. Commissioner*.<sup>50</sup> In this case, the corporation made contributions to its retirement plans for two employees, who were both within the prohibited group,<sup>51</sup> but inadvertently omitted a contribution for

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benefit should be easy to compute. An employee, who started in 1950 and who was to retire at his normal retirement date in 1980, would be entitled to a plan benefit of 25% of compensation (10 years times 1/2 of 1% plus 20 years times 1%). However, if the plan administrator does not limit the past service credit benefit to years of service prior to 1960, a gross distortion occurs. The plan benefit for the above hypothetical employee in 1975 would be only 17 1/2%, calculated as follows: 25 years times 1/2 of 1% plus 5 years times 1%. By the time this employee reached his normal retirement date in 1980 his benefit would be 15% of compensation. Another example is easily conceptualized in a defined contribution plan in which the trust's earnings (or losses) are incorrectly allocated to the participant's separate account.

47. As a result of an actuarial or accounting error, a plan participant may receive an underpayment or an overpayment from a plan. *See, e.g.,* *Bailey v. Brick Layers Tenders Local 59*, 80 Misc. 2d 583, 363 N.Y.S.2d 472 (Civ. Ct. N.Y. 1975); *First Nat'l City Bank v. McManus*, 29 N.C. App. 65, 223 S.E.2d 554 (1976); *Wilson v. Westinghouse Elec. Corp.*, 85 Wash. 2d 78, 530 P.2d 298 (1975); Rev. Rul. 69-190, 1969-1 C.B. 131.

48. 67 T.C. 167 (1976).

49. *Id.* at 174. An important point in the court's analysis of the trustee's intent was that the sponsor of the plan in issue initially sought a qualification letter, but did not complete the submission process when the IRS raised questions concerning the plan and the allocation formula. This subsequently became the source of the discrimination-in-operation. *Id.* at 169, 175.

50. 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610.

51. *See* I.R.C. § 401(a)(4). The plan may not discriminate in favor of the "prohibited group" which includes officers, shareholders, and highly compensated employees.

the other eligible employee, who was not within the prohibited group. When an IRS audit discovered this omission, the taxpayer “offered” to reallocate past contributions among all three employees as if the contributions had been made correctly. This “offer” was made on the condition that the IRS would not disqualify the plans. The taxpayers further argued that failure to accept this “offer” would constitute an abuse of discretion by the Commissioner. The Tax Court noted the absence of a Code provision governing the retroactive correction of administrative errors; it therefore found no *statutory* guidelines to aid it in assessing whether the Commissioner would, in fact, abuse his discretion by a refusal to qualify a plan that retroactively corrected its “bookkeeping errors.”

The Tax Court, as in *Quality Brands*, then reserved judgment “on the question whether and under what circumstances respondent would be justified in refusing to confer qualified status on a plan when an inadvertent error in administration such as the one involved in this case, had been in fact voluntarily rectified by those charged with operating the Plan.”<sup>52</sup> The Court concluded that failure to include the eligible employee was clearly discriminatory, and because the plan did not voluntarily correct the error, it was disqualified under section 401(a).

The most recent Tax Court case in this area, a decision by Judge Dawson, is *Forsyth Emergency Services, P.A. v. Commissioner*.<sup>53</sup> The issue was whether the improper operation of a plan’s eligibility test can be retroactively cured by additional admissions and contributions. In *Forsyth*, certain employees were inadvertently omitted from the corporation’s plan because of an error in the interpretation of the plan’s participation entry date. After an IRS audit and issuance of an adverse determination letter, the taxpayer made additional contributions (with interest) to rectify the omission. Concluding that the plan in operation was not technically qualified because of a failure to satisfy the coverage tests, the court held that:

Unfortunately, we find no support for retroactive cure in this case in the code, regulations, or case law.

. . . There is no allowance in . . . [Code §] 402(a) for an excuse to be offered to neutralize the effect of an objectionable operation,

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52. 68 T.C. at —, [1977] TAX CT. REP. (CCH) Dec. 34,610. This holding in *Ludden*, as well as the development of a “bookkeeping-error” doctrine, draw support from *Myron v. United States*, 550 F.2d 1145 (9th Cir. 1977).

53. 68 T.C. —, [1977] TAX. CT. REP. (CCH) Dec. 34,627.

irrespective of whether the cause resulted from an honest mistake, inadvertence, erroneous advice of counsel, or intentional misdirection.<sup>54</sup>

Judge Dawson, writing for the court, also discussed the case law that allegedly endorsed the allowance of retroactive bookkeeping error cures. *Aero Rental* was inapplicable because it concerned only temporary form defects, none of which affected the operation of a plan or caused discrimination-in-operation. *Ray Cleaners, Inc. v. Commissioner*<sup>55</sup> was also inapplicable because the administrative error which excluded three eligible employees did not cause the discrimination-in-operation that occurred in *Forsyth*. In addition, Judge Dawson rejected the "bookkeeping error" concept that was intimated, but reserved, in *Ludden* and *Quality Brands*.

The impact of *Quality Brands*, *Ludden*, and *Forsyth* is uncertain. Judge Scott's opinion in *Ludden* is considerably less critical of the "bookkeeping error" concept than Judge Dawson's language in *Forsyth*. Moreover, it is uncertain what interpretation other courts will give these cases. It is safe only to conclude that the final position on this issue by the Tax Court and other competent courts is unclear.

Both *Ludden* and *Forsyth* involved the misapplication of coverage requirements which resulted in clear discrimination-in-operation. It is unknown whether the Tax Court would allow the retroactive cure of bookkeeping errors that do not affect coverage. If the Tax Court attempts to delineate on a case by case basis those operational errors that can be retroactively cured, considerable litigation, reflecting the multitude of possible bookkeeping errors, will result. The Tax Court has not considered the case of a bookkeeping error that does not result in discrimination-in-operation. Unfortunately, the *Forsyth* decision may impede both acceptance and development of a broader doctrine that would permit retroactive cure of all bookkeeping errors regardless of whether *temporary* discrimination-in-operation has resulted. The rationale for such a doctrine is that where only inadvertent, human errors have occurred, the plan and all its participants are made "whole" without disqualification. The Code, moreover, does not prevent the recognition of this doctrine which, as current practice indicates, fosters the liberal purposes of pension plan law.

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54. *Id.* at —, [1977] TAX CT. REP. (CCH) Dec. 34,627.

55. 27 T.C.M. (CCH) 23 (1968).

If a bookkeeping error is discovered during self-review of a plan, prior to an IRS audit, the plan should take immediate steps to remedy the situation. *Quality Brands, Ludden, and Forsyth* were all instances in which the bookkeeping error was discovered as a result of an IRS audit. This fact not only emphasizes the importance of self-review, but also leaves open the possibility, although unlikely, of a different result when a plan finds and cures its own error.

The practical problem in the self-review process is how to correct such bookkeeping errors when and if they are discovered. Suppose, for example, that a defined contribution profit sharing plan's eligibility test is grossly misapplied for several years. The result may be that a number of employees will fail to enter the plan in a timely fashion and will not receive the correct contribution and trust income allocations. There are two basic options open to a plan upon discovery of such an error. First, it may ignore the past errors, operate the plan correctly in the future, and hope the statute of limitations runs before an IRS audit of the plan uncovers the error.<sup>56</sup> Besides disqualification of the plan if the error is discovered,<sup>57</sup> this action also raises the possibility of litigation by participants,<sup>58</sup> or criminal sanctions.<sup>59</sup>

The second, more viable option is retroactively, voluntarily, and promptly to cure these "bookkeeping errors," and prospectively to operate the plan correctly. The issue then is whether to disclose to the government the error and corrective action taken. Although many factors

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56. The statute of limitations for plans that have filed the required informational returns is three years. See I.R.M.-Audit 45(10) 5-2 § 613.6(1). The returns required prior to ERISA were Forms 990-P and 990-T. See I.R.M.-Audit 45(10) 5-2 § 210(3). The primary ERISA returns are Forms 5500 and 990-T. See generally Zid, *Meeting the Reporting and Disclosure Requirements, Handling the Accountant's Problems in his Auditing of the Plan*, 1976 N.Y.U. 34th INST. FED. TAX. 1149.

57. See, e.g., *Forsyth Emergency Servs., P.A. v. Commissioner*, 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,627. If a judicial doctrine that allows retroactive cure of bookkeeping errors develops, the question of burden of proof will undoubtedly arise. Absent a specific rule, the general rule of civil tax litigation under which the taxpayer (here the plan or employer) bears the burden of proof will prevail. See Tax Court Rule 142, 60 T.C. 1133-34 (1973). This result is reasonable because the taxpayer has knowledge of the surrounding events and circumstances.

58. See Act § 502.

59. Depending on the specific errors involved, a bookkeeping error may place the plan administrator in a difficult position with respect to the correctness of informational returns filed and to be filed, and may thereby subject him to various criminal sanctions. See, e.g., 18 U.S.C. § 1001 (1970); I.R.C. § 7203; Act § 510.

influence this decision, it is presently recommended<sup>60</sup> that a plan make such a disclosure, at least to the extent that such action affects a pending determination letter request or the plan's informational returns that were previously filed with the various governmental agencies.<sup>61</sup>

### (iii) *Major Operational Considerations*

Although a plan is operated according to its terms and is administered without bookkeeping errors, there are other operational problems which may result in its disqualification. Several requirements in section 401 address the operational status of a plan, including the exclusive benefit rule<sup>62</sup> and the nondiscrimination mandate.<sup>63</sup> Because these requirements are incapable of precise definition,<sup>64</sup> conflicting interpretations may be

60. This action is recommended because the IRS's present position is to cooperate fully with plans in this situation. See Simmons, *Dangers in the Disqualification of Pension Plans*, 1976 N.Y.U. 34th INST. FED. TAX. 507. Note, however, that if the principle in *Forsyth* becomes the rule, the general approach of cooperation and disclosure will be significantly, and adversely, affected.

61. See note 59 *supra*.

62. See I.R.C. § 401(a) & 401(a)(2). *Feroletto Steel Co. v. Commissioner*, 69 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610.

63. See I.R.C. § 401(a)(4) which provides in pertinent part:

A Trust . . . forming part of a . . . plan of an employer for the exclusive benefit of his employees . . . shall constitute a qualified trust under this section—(4) if the contributions or benefits provided under the plan do not discriminate in favor of employees who are—(A) officers, (B) shareholders, or (C) highly compensated.

See also Treas. Reg. § 1.401-1(b)(3), T.D. 6203, 1956-2 C.B. 225.

64. See Treas. Reg. § 1.401-4(a)(2)(iii), T.D. 6203, 1956-2 C.B. 232.

For cases interpreting section 401 requirements, see the following:

*Allocation*: *Auner v. United States*, 440 F.2d 516 (7th Cir. 1971); *Charles E. Smith & Sons, Co., v. Commissioner*, 184 F.2d 1011 (6th Cir. 1950), *cert. denied*, 340 U.S. 953 (1951); *Gold Seal Products Co. v. United States*, 73-2 U.S. Tax Cas. 82,436 (N.D. Ala. 1973); *Quality Brands, Inc. v. Commissioner*, 67 T.C. 167 (1976); *Robertson v. Commissioner*, 61 T.C. 727 (1974).

*Coverage*: *Myron v. United States*, 550 F.2d 1145 (9th Cir. 1977); *Container Service Co. v. United States*, 478 F.2d 777 (6th Cir. 1973); *George Loevsky v. Commissioner*, 471 F.2d 1178 (3d Cir.), *cert. denied*, 412 U.S. 919 (1973); *Cornell-Young Co. v. United States*, 469 F.2d 1318 (5th Cir. 1972); *Commissioner v. Pepsi-Cola Niagara Bottling Corp.*, 399 F.2d 390 (2d Cir. 1968), *rev'g* 48 T.C. 75 (1967); *John Duguid & Sons, Inc. v. United States*, 278 F. Supp. 101 (N.D.N.Y. 1967); *Wisconsin Nipple Fabricating Corp. v. Commissioner*, 67 T.C. 490 (1976), *appeal docketed*, No. 77-1792 (7th Cir. Aug. 8, 1977); *Babst Servs., Inc. v. Commissioner*, 67 T.C. 131 (1976); *Packard v. Commissioner*, 63 T.C. 621 (1975); *Liberty Mach. Works, Inc. v. Commissioner*, 62 T.C. 621 (1974), *aff'd per curiam*, 518 F.2d 554 (8th Cir. 1975); *Bernard McManamy, Contractors, Inc. v. Commissioner*, 54 T.C. 1057 (1970), *aff'd per curiam*, 442 F.2d 359 (1971); *Loper Sheet Metal, Inc.*, 53 T.C. 385 (1969); *Ed & Jim Fleitz, Inc.*, 50 T.C. 384 (1968); *Peter F. Mitchell Corp.*, 27 T.C.M. (CCH) 1030 (1968), *supplemented by*, 28 T.C.M. (CCH) 425 (1969); *Ray Cleaners, Inc.*, 27 T.C.M. (CCH) 23 (1968); *Armanco Prods.*, 49 T.C. 174 (1967); *Ryan School Retirement Trust*, 24 T.C. 127 (1955).

asserted by a plan and an IRS agent. The problems in this area are magnified in smaller plans where operational discrimination in favor of the prohibited group is often extremely clear.

Once a potential discrimination-in-operation problem is uncovered by the plan in the self-review process, several alternatives are available. Of course, the problem may simply be ignored. The plan may, on the other hand, request an informal, non-binding determination by the local IRS office as to whether the operational problem exists and how it may be remedied. Although the plan is not entitled to receive or rely on such a discussion or opinion,<sup>65</sup> it may provide a number of viable alternatives. Finally, and regardless of whether the plan pursues an advisory opinion, the plan may play it "safe" and take action to eliminate the problem.

### III. AUDIT PROCESS

An audit of a plan can arise indirectly from an audit of the employer's income or excise tax returns, or directly from an audit of the plan's returns.<sup>66</sup> At the present time, the IRS Audit Manual suggests that various subjects be considered during an examination of a plan or plan's trust.<sup>67</sup> During an audit, an IRS agent may discover defects in the form or

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*Definition of Employee:* Burnetta v. Commissioner, 68 T.C. 387 (1977); Jim's Window Serv., Inc. v. Commissioner, 33 T.C.M. (CCH) 563 (1974).

*Definition of Supervisor:* Marjorie F. Birnie, 12 T.C.M. (CCH) 867 (1953).

*Discrimination:* Quality Brands, Inc. v. Commissioner, 67 T.C. 167 (1976); Betty C. Stockvis 10 T.C.M. (CCH) 74 (1951), Volckening, Inc. v. Commissioner, 13 T.C. 723 (1949).

*Integration:* Simmons v. United States, 71-2 U.S. Tax Cas. 87,339 (W.D. Tenn. 1971).

*Loans, Notes, Trusts:* Central Motor Co. v. United States, 76-1 U.S. Tax Cas. 83,523 (D.N.M. 1976); Advance Constr. Co. v. United States, 356 F. Supp. 1267 (N.D. Ill. 1972); Lansing v. Commissioner, 35 T.C.M. (CCH) 1421 (1976); Trebotich v. Commissioner, 57 T.C. 326 (1971), *aff'd*, 492 F.2d 1018 (9th Cir. 1974).

*Past Service:* Sherman Constr. Corp. v. United States, 358 F. Supp. 446 (E.D. Va. 1973).

*Vesting:* United States v. Hall, 398 F.2d 383 (8th Cir. 1968).

65. See I.R.M.-Audit 45(10) 2.7. The IRS's present practice does not require identification of the specific plan, and thus allows the plan (or its representatives) the safety of anonymity in pursuing such requests. See also 9 J. MERTENS, *supra* note 2, § 49.94.

66. See I.R.M. (CCH) 45(10) 1.1; I.R.M. (CCH) 45G-279.

67. See I.R.M.-Audit 45(10) 5 § 210. The manual contains a detailed description of the items that may be audited, including, but not limited to, (i) operational features such as coverage, vesting, compensation, not following the plan, termination, etc., (ii) contribution deductions, timely payments, property form, I.R.C. § 404 limitations; (iii) actuarial considerations, (iv) special problems of profit sharing plans, (v) executive benefit provisions, and (vi) guidelines for revocations. Additional ERISA items that may also be audited include the break-in-service rules, vesting standards, hours of service rules, and I.R.C. § 415 limitations.

operation of the plan. The discovery of a problem in form, bookkeeping-administration, or operation during an audit does not automatically cause the plan to be disqualified; there is some authority, in each instance, to prevent the plan's disqualification.<sup>68</sup>

### A. *Form Defects*

One possible cure for defects in a plan's form may be a timely or discretionary amendment, as discussed in section II(A) above. In addition, although the IRS issues a favorable qualification letter, a plan may nevertheless have form defects which were not corrected in the qualification process. Thus, there may be errors in the eligibility computation period or integration formula<sup>69</sup> which could lead to operational, and even discriminatory, problems. In these circumstances, the plan may invoke section 7805(b) to preserve its qualified status. Section 7805(b) provides: "The Secretary . . . may prescribe the extent, if any, to which any ruling or regulation, relating to the Internal Revenue laws, shall be applied without retroactive effect."<sup>70</sup>

Under this provision, the Secretary of the Treasury will not revoke a determination letter ruling, except in unusual circumstances, if the following criteria are met:<sup>71</sup>

- (i) there has been no misstatement or omission of material facts in the application;<sup>72</sup>

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68. See notes 69-88 *infra* and accompanying text.

69. See I.R.C. § 401(a)(5).

70. I.R.C. § 7805(b) was originally enacted in the Revenue Act of 1921, ch. 136, § 1314, 42 Stat. 227 (current version at I.R.C. § 7805(b)). This provision was enacted to prevent undue hardship resulting from changes in newly issued Treasury Department regulations. J. SEIDMAN, LEGISLATIVE HISTORY OF FEDERAL INCOME TAX LAWS 886-87 (1938). I.R.C. § 7805(b) finally took its present form in 1934. Revenue Act of 1934, ch. 277, § 506, 48 Stat. 680 (now I.R.C. § 7805(b)).

This section grants considerable discretion to the Secretary to apply his decisions (whether by regulation or ruling) retroactively. This authority, however, must not be abused. *Automobile Club v. Commissioner*, 353 U.S. 180 (1957); *Niagara Hudson Power Corp. v. Leventritt*, 340 U.S. 336 (1951); *LeSavoy Foundation v. Commissioner*, 238 F.2d 589 (3d Cir. 1956); *United States ex rel. Adamantides v. Neely*, 191 F.2d 997 (7th Cir. 1951); *H.S.D. Co. v. Kavanagh*, 191 F.2d 831 (6th Cir. 1951); *Valley Mold & Iron Corp. v. NLRB*, 116 F.2d 760 (7th Cir. 1940); *Merlin Rockwell Corp. v. NLRB*, 116 F. 2d 586 (2d Cir. 1940). Cf. *Ludden v. Commissioner*, 68 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610 (Commissioner did not abuse his discretion where there were no statutory criteria to provide him with guidance in circumstances in issue).

71. See Rogovin, *The Four R's, Regulations, Rulings, Reliance and Retroactivity—A View From Within*, reprinted in STAND. FED. TAX REP. (CCH) ¶ 5980A.0152-.0157. See also 9 J. MERTENS, *supra* note 2, § 49.95; I.R.M.—Audit 45(10) § 711(1).

72. It is extremely important that full disclosure of all facts necessary for a determination letter be made in the application. Absent full disclosure, I.R.C. § 7805(b) is useless.

- (ii) the facts subsequently developed are not materially different from the facts upon which the ruling was based;
- (iii) there has been no change in the applicable law;<sup>73</sup>
- (iv) the ruling was issued with respect to a prospective or proposed transaction;<sup>74</sup> and
- (v) the taxpayer acted in good faith in relying on the ruling and the retroactive revocation will be to his detriment.<sup>75</sup>

A similar test, under Revenue Procedure 72-3, is applied to revenue rulings which may affect the plan's continued qualification.<sup>76</sup>

With respect to form defects, the requirements of section 7805(b) and Revenue Procedure 72-3 are relatively easy to meet. Full disclosure of all the material facts,<sup>77</sup> and operation of the plan in accordance with its exact terms, will demonstrate the critical elements of full disclosure and reliance.<sup>78</sup> The third essential element in a section 7805(b) test—that the facts subsequently developed are not materially different than the facts as submitted—should not be particularly important in a defense to form defects.

The final defense to a form defect discovered in an IRS audit is an extension of the Tax Court's holding in *Aero Rental v. Commissioner*.<sup>79</sup> Specifically, if the operation of a plan is not actually affected by a plan provision or its absence, it should be possible to amend retroactively the plan's form.<sup>80</sup>

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*See, e.g.,* Lowry Hosp. Ass'n v. Commissioner, 66 T.C. 850 (1976); Harwood Assocs. v. Commissioner, 63 T.C. 255 (1974); Lorain Ave. Clinic, 31 T.C. 141 (1958).

73. Until all the rules of ERISA are established, there will continue to be major changes in the applicable law, which may prevent extensive use of either I.R.C. § 7805(b) or Rev. Proc. 72-3 defenses to retroactive revocation of a plan's qualified status. It is hoped, however, that a liberal, and practical, interpretation of this requirement by the IRS will alleviate some of the difficulties encountered by all plans attempting to comply with ERISA.

74. It is generally recognized that plan determination letters fall within the "prospective" category: a plan, thus, has little practical difficulty satisfying this element. *See* Rogovin, *supra* note 71, ¶ 5980A.0157.

75. *See, e.g.,* Knetsch v. United States, 348 F.2d 932 (Ct. Cl. 1965) (transaction consummated, thus no acts constituting basis for reliance); Bornstein v. United States, 345 F.2d 558 (Ct. Cl. 1965) (reliance not proved). Administration in accordance with a plan's exact terms may provide proof of the taxpayer's reliance and should be applied to both form and operational problems that result from form defects.

76. Rev. Proc. 72-3, 1972-1 C.B. 698, § 13.05.

77. *See* note 72 *supra* and accompanying text.

78. *See* note 75 *supra* and accompanying text.

79. 64 T.C. 331 (1975); *see* notes 32-33 *supra* and accompanying text.

80. *See* notes 14-35 *supra*.

## B. Operational Considerations

As noted earlier, there are several categories of operational problems—minor, bookkeeping-administrative, and major. *Time Oil Co. v. Commissioner*<sup>81</sup> provides the primary defense to disqualification of a plan for a minor operational problem discovered either in the audit or self-review process.

If the IRS discovers a bookkeeping-administrative error during an audit, the issues raised in the *Quality Brands, Ludden, Forsyth* trilogy<sup>82</sup> become relevant. The emergence of a doctrine that would allow voluntary, retroactive cure of bookkeeping errors would have a direct impact on the IRS's treatment of similar plan errors discovered in the audit process. In fact, despite the hard line taken by Judge Dawson in *Forsyth*, other courts have developed a more reasonable approach to the problem of retroactive cures. In *Quinn v. United States*,<sup>83</sup> which preceded the *Quality Brands* trilogy, a district court considered whether a plan's qualified status should be revoked for the disbursement of "improperly" contributed funds to an improper plan "participant."<sup>84</sup> The court, reasoning that a plan should not be severely penalized when there has been no *irrevocable* benefit to the employer or prejudice to the employee, flatly rejected the IRS's effort to disqualify the entire plan.<sup>85</sup> The court suggested alternative means to cure future occurrences of this particular problem which would preclude the harsh consequences of disqualification.<sup>86</sup>

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81. 258 F.2d 237 (9th Cir. 1958); see notes 38-42 *supra*.

82. See notes 48-55 *supra* and accompanying text.

83. 77-1 U.S. Tax Cas. 86,863 (D. Md. 1976).

84. In *Quinn*, the corporation deducted, as compensation, money paid to the stockholder president's father, who was 85 years of age and sick. Since the compensation was unreasonable under I.R.C. § 162(a), the contribution should not have been made to the company's profit sharing plan for the father.

85. 77-1 U.S. Tax Cas. at 86,866-68 (D. Md. 1976).

86. The court in *Quinn* suggested two solutions to this problem, which was complicated because the funds in issue had already been distributed to the father's estate. First, the corporation's deduction would simply be disallowed in an amount equal to the unreasonable compensation. Secondly, the company would make a nondeductible contribution, equal to the disbursement, and effect a retroactive reallocation of the amounts in issue. The court noted that if the distribution to the estate had not been made, the plan's existing trust funds could easily be reallocated.

This philosophy echoes the Ninth Circuit's in *Time Oil Co. v. Commissioner*, 258 F.2d 237 (9th Cir. 1958), and the Tax Court's in *Aero Rental v. Commissioner*, 64 T.C. 331 (1975); it has traditionally been well received by some IRS agents.

If the IRS discovers a serious, discriminatory operational defect in the audit process, such as a coverage, vesting, exclusive benefit, or prohibited group problem, the plan will have little success effecting voluntary solutions. In this context, the application of section 7805(b) is also somewhat limited, although arguably it may be applied to those operational defects that arise out of a literal application of the plan's qualified and approved form.<sup>87</sup> In those situations in which operational problems are not directly related to the plan's form, section 7805(b) may not be applicable because two elements of the test, that there is no omission of material facts and that the discriminatory, operational facts are not materially different from the facts in the application,<sup>88</sup> will be difficult to fulfill. Because of the highly technical and factual nature of non-form related operational problems, it would be unusual if the same facts involved in the IRS's audit finding were required, or even considered in the determination letter process. A theoretical solution to this problem, and a possible means to invoke section 7805(b) in any serious, operational defect circumstance, would be to link the foreseeability and inevitability of a plan form defect to the actual operational problem in issue. This would obviate the requirement that intense factual disclosure has been associated with the application.

#### IV. THE TAX EFFECTS OF A PLAN'S DISQUALIFICATION

There are direct and immediate tax effects on the employees, the

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87. Some examples of I.R.C. § 7805(b)'s application may be as follows:

(1) A § 7805(b) application should be successful if a plan is found not to integrate properly where the formula for integration was applied as written in the plan, and approved in the qualification process, but did not integrate correctly at that time. Of course, the IRS will insist on prospective changes if the plan is to maintain its qualified status.

(2) A § 7805(b) application should also be successful if a plan received a favorable determination letter based on salaried-only employee coverage, but upon audit the coverage, in effect, was found to be discriminatory. Nevertheless, if the facts developed on audit are substantially the same facts on which the letter was based, the determination letter will not be revoked retroactively. Again, prospective changes may be needed to preserve the continuing qualified status of the plan.

(3) A § 7805(b) application would probably not be successful in an IRS challenge to a vesting formula's alleged discriminatory application that is based on employee turnover, because usually no turnover information is submitted with an application for determination. Thus, the second element may not be present because the subsequently developed facts cannot be compared to the facts on which the determination letter was based.

88. The IRS, however, has on occasion utilized § 7805(b) to preserve the continuing tax qualification of pension plans that have operational problems when necessary to protect and benefit the plan's participants.

employer, and the trust associated with a plan that becomes disqualified.<sup>89</sup>

A. *Effects on the Employees*

Section 402(b), entitled "Taxability of Beneficiary of Nonexempt Trust," provides:

Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under section 501(a) shall be included in the gross income of the employee in accordance with section 83 (relating to property transferred in connection with performance of services), except that the value of the employee's interest in the trust shall be substituted for the fair market value of the property for purposes of applying such section. The amount actually distributed or made available to any distributee by any such trust shall be taxable to him in the year in which so distributed or made available, under section 72 (relating to annuities), except that distributions of income of such trust before the annuity starting date (as defined in section 72(c)(4)) shall be included in the gross income of the employee without regard to section 72(e)(1) (relating to amount not received as annuities). A beneficiary of any such trust shall not be considered the owner of any portion of such trust under subpart E of part I of subchapter J (relating to grantors and others treated as substantial owners).

This section is composed of three sentences and each will be examined separately. It must be noted that this provision encompasses both non-qualified and disqualified plans. The former were never intended to be qualified under section 401(a), while the latter are plans that were, but are no longer, qualified.

(i) *First Sentence of Section 402(b)*

The first sentence of section 402(b) was significantly revised as part of the Tax Reform Act of 1969,<sup>90</sup> effective on August 1, 1969. Prior to that date, the first sentence of section 402(b) provided as follows:

Contributions to an employees' trust made by an employer during a taxable year of the employer which ends within or with a taxable year of the trust for which the trust is not exempt from tax under

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89. Once the IRS has made a final, adverse determination with respect to a plan's qualified status, it may be appealed to the United States Tax Court, *see* I.R.C. § 7476, or the district courts, *see* I.R.C. § 7422.

90. Pub. L. No. 91-172, § 321(b)(1), 83 Stat. 487.

section 501(a) shall be included in the gross income of an employee for the taxable year in *which the contribution is made to the trust in the case of an employee whose beneficial interest in such contribution is nonforfeitable at the time the contribution is made.*<sup>91</sup>

The italicized language required a participant in a disqualified plan to include in his income the nonforfeitable contribution to that plan which was made for him by an employer. An employee's interest in such a contribution was "nonforfeitable" only if "at the time the contribution was made . . . there [was] *no* contingency under the plan which may cause the employee to lose his rights in the contribution."<sup>92</sup> Thus, if a plan contained any contingent provisions that might cause an employee to lose any or all of his rights,<sup>93</sup> or if the employee's interest became nonforfeitable in a year other than the year the contribution was made,<sup>94</sup> the employee did not have to include in his gross income his interest in an employer's contribution to a disqualified plan.

The italicized language was, however, deleted by the 1969 changes and, in lieu thereof, section 402(b) was amended to incorporate the provisions of section 83, which provides in pertinent part:<sup>95</sup>

(a) General Rule—If, in connection with the performance of services, property is transferred to any person other than the person for whom such services are performed, the excess of—

(1) the fair market value of such property (determined without regard to any restriction other than a restriction which by its terms will never lapse) at the first time the rights of the person having the beneficial interest in such property are transferable or are not subject to a substantial risk of forfeiture, whichever occurs earlier, over

(2) the amount (if any) paid for such property . . . .

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91. Int. Rev. Code of 1954, Pub. L. No. 83-591, § 402(b), 68A Stat. 3 (emphasis added).

92. Treas. Reg. § 1.402(b)-1(a)(2)(i), T.D. 6203, 1956-2 C.B. 245 (emphasis added). The current regulations under I.R.C. § 402(b) have not been changed to account for the 1969 revision.

93. Many plans had "bad boy" clauses which could create a forfeiture of a participant's entire interest if he were "disloyal," "dishonest," committed a "crime," or "competed" against or toward the employer. Under pre-ERISA law, although there was a split in authority, such clauses were generally enforceable. ERISA has for the most part eliminated bad boy clauses. *But see* Treas. Reg. § 1.411(a)-4(c) Ex. 1.

94. Treas. Reg. § 1.402(b)-1(a)(1), T.D. 6203, 1956-2 C.B. 244.

95. For a history of I.R.C. § 83, see J. MERTENS, *supra* note 2, Commentary § 83.

The section 83 phrase "fair market value of the property" is specifically replaced in section 402(b) with "the value of the employee's interest in the trust." One obvious impact of this 1969 revision is to impose a section 83 test on section 402(b) and thus accelerate the time and broaden the conditions under which the employee must include in income the employer contributions to a disqualified plan.

In June, 1971, the Commissioner issued proposed regulations for the new section 402(b). Although these regulations have not been finalized, close scrutiny is necessary to determine the current IRS interpretation of section 402(b).<sup>96</sup>

The proposed regulations are divided into four subsections. The first discusses the taxation of plan participants resulting from employer contributions made after August 1, 1969;<sup>97</sup> the second<sup>98</sup> deals with the taxation of plan participants when their rights in a nonexempt trust change from "nonvested" to "vested." These two subsections correspond to the first sentence of section 402(b). The third subsection<sup>99</sup> relates to the second sentence of section 402(b) which concerns the taxation of distributions from a nonexempt trust under section 501(b); this second sentence will be examined separately.<sup>100</sup> The final subsection<sup>101</sup> addresses the taxation of plan participants by reason of employer contributions made on or before August 1, 1969, and corresponds with the section 402(b) regulations technically now in effect. In addition to the proposed regulations for section 402(b), the Commissioner has issued proposed regulations for section 83.<sup>102</sup>

The first subsection of the proposed regulations to section 402(b) would include in an employee's income any employer contribution made on behalf of an employee after August 1, 1969, to a trust which, in that year, is not exempt under section 501(a). The inclusion, however, is only to the extent that the employee's interest in such contribution is "vested"

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96. See Prop. Reg. § 1.402(b) (1971).

97. *Id.* § 1.402(b)-1(a).

98. *Id.* § 1.402(b)-1(b).

99. *Id.* § 1.402(b)-1(c).

100. See notes 135-49 *infra* and accompanying text.

101. See Prop. Reg. § 1.402(b)-1(d) (1971).

102. See Prop. Regs. §§ 1.83-1 to 1.83-8. The proposed regulations to both I.R.C. §§ 83 and 402(b) were issued on June 3, 1971, yet neither are final.

at the time it was made.<sup>103</sup> "Vested" refers to the employee's beneficial interest in such contribution (or premium) which is "transferable" or "not subject to a substantial risk of forfeiture."<sup>104</sup> "Transferable," in this context, means that a plan participant's rights in the property can be transferred to any person other than the transferor of the property, but only if such rights are not subject to substantial risk of forfeiture.<sup>105</sup> Because of the limited rights of a plan participant to assign, pledge, or alienate plan benefits, "transferability" is not crucial.<sup>106</sup> The concept of "substantial risk of forfeiture," however, is critical under this regulation, in assessing whether an employee's beneficial interest is "vested."

The proposed regulations to section 83 provide that the rights of a person are subject to a "substantial risk of forfeiture" if such person's rights to full enjoyment of the property are conditioned upon the future performance, or the refraining from the performance, of substantial services by any individual.<sup>107</sup> Despite some general guidelines,<sup>108</sup> whether "services" are "substantial" will be judged on all the facts and circumstances.<sup>109</sup> Some specific exceptions are provided in the regulations, however, and a plan provision which causes an employee to return or lose his interest if he commits a crime will not be considered a substantial risk of forfeiture.<sup>110</sup> Similarly, an anticompetitor or consulting agreement will not ordinarily be considered a substantial risk of forfeiture.<sup>111</sup> The proposed regulations set forth several examples of the application of these rules;<sup>112</sup> one particularly relevant example, similar to a graded vesting schedule of a plan, is as follows:

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103. See Prop. Reg. § 1.402(b)-1(a)(1) (1971).

104. *Id.* § 1.402(b)-1(a)(2).

105. See I.R.C. § 83(c)(2); Prop. Reg. § 1.83-3(c) (1971).

106. See I.R.C. § 401(a)(13).

107. See Prop. Reg. § 1.83-3(c)(1) (1971).

108. The proposed regulation states only: "The regularity of the performance of services and the time spent in performing such services tend to indicate whether services are substantial. In addition, the fact that the person performing such services has the right to decline to perform such services may tend to establish that services are insubstantial." *Id.*

109. *Id.*

110. *Id.* The Tax Court, in *Burnetta v. Commissioner*, 68 T.C. 387 (1977) has accepted this position. The Tax Court has also concluded that a "dishonesty," "bad-boy" clause will not constitute a substantial risk of forfeiture. See *Ludden v. Commissioner*, 68 T.C. —, [1977] TAX. CT. REP. (CCH) Dec. 34,610.

111. See Prop. Reg. § 1.83-3(c)(1) (1971).

112. *Id.* § 1.83-3(c)(2) Ex. 1-4.

On November 25, 1971, corporation X gives to E, an employee, in connection with his performance of services to corporation X, a bonus of 100 shares of corporation X stock. Under the terms of the bonus arrangement E is obligated to return the corporation X stock to corporation X if he terminates his employment for any reason. However, for each year occurring after November 25, 1971, during which E remains employed by corporation X, E ceases to be obligated to return 10 shares of the corporation X stock. Since in each year occurring after November 25, 1971, for which E remains employed he is not required to return 10 shares of corporation X's stock, E's rights in 10 shares each year for 10 years cease to be subject to a substantial risk of forfeiture for each year he remains so employed.<sup>113</sup>

The first subsection of the section 402(b) proposed regulations also determines the amount of the employer's contribution attributable to the employee.<sup>114</sup> In defined contribution plans,<sup>115</sup> individual accounts are maintained so that the amount of the employer's contribution per participant is easily determinable. In defined benefit plans,<sup>116</sup> however, the employer's contribution to each plan participant is determined by a specific formula,<sup>117</sup> or by other generally accepted actuarial principles.<sup>118</sup>

The proposed rules and definitions are illustrated by an example:

Assume a profit sharing plan was initially adopted and established on January 1, 1976 by a single corporate employer, which corporation was formed on January 1, 1965. Both the employer and the trust use the calendar year for federal income tax purposes. The profit sharing plan provides for immediate participation and a vesting schedule of ten percent per year for each year of service, with full vesting after ten years of service and with all years of an employee's service, even those prior to the adoption of the plan, credited. There are no plan provisions providing for divestment for cause or otherwise. On December 31, 1976, Employee A had ten years of service, Employee B had five years of service, and Employee C had one year of service. The employer makes a contribution on December 31, 1976 which is allocated to each employee as follows: A — \$3,000.00, B — \$2,000.00, and C — \$1,000.00. If the trust of this plan is not exempt for the year 1976, each employee would have to

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113. *Id.* at Ex. 2.

114. *Id.* § 1.402(b)-1(a)(3).

115. *See* Act § 3(34).

116. *Id.* § 3(35).

117. *See* Prop. Reg. § 1.402(b)-1(a)(3) (1971).

118. *Id.*

include in his gross income the following amounts: *A*—\$3,000.00, *B*—\$1,000.00, and *C*—\$100.00, which is determined by taking the employer's allocated contribution and multiplying by the participant's vested interest.

The employees in the above hypothetical would be charged with income even though they were not in receipt of cash.<sup>119</sup> In addition, the employee and employer may be subject to withholding and social security tax liability on the amount of the employee's income.<sup>120</sup> Despite these results, this is a correct application of the statutory requirements of section 402(b). If the plan in the above hypothetical were requalified for 1977 and subsequent years, the trust would be exempt from taxation under section 501(a) and the employees would not be required to include in their income any additional employer contributions to the plan.<sup>121</sup>

The second subparagraph of the proposed regulations to section 402(b) is much broader in its potential impact on the participants in a plan that loses its qualified status. The proposed regulation<sup>122</sup> provides in part:

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119. The final determination with respect to a plan's disqualification usually occurs several years after the contribution was made, which means the employee would also owe interest on any additional income taxes. Disqualification of a plan alters its function; rather than being a "fringe benefit," it almost immediately becomes a detriment, because the employee must pay income taxes with his own after tax dollars without receiving any funds from the plan. In addition, the employee's tax return will be subjected to at least a cursory IRS audit. Even if the employer awarded "bonuses" to employees to cover their tax liability, the bonuses would be subject to still additional income taxes. Note, however, that any amount included in his income would be added to the employee's basis and applied against any amounts later distributed to him. *See* Prop. Reg. § 1.402(b)-1(b)(5) (1971).

120. *See* notes 154-56 *infra* and accompanying text.

121. *See* Treas. Reg. § 1.402(a)-1(a)(1)(i), T.D. 6203, 1956-2 C.B. 234.

122. Prop. Reg. § 1.402(b)-1(b)(1) (1971) (emphasis added). An equally important part of this regulation provides:

If rights of an employee under a trust during a taxable year of the employee (ending after August 1, 1969) which ends within or with a taxable year of the trust for which the trust is not exempt under section 501(a) change from nonvested to vested, the value of the employee's interest in the trust on the date of such change shall . . . be included in his gross income for the taxable year.

This proposed regulation would have a dramatic impact on a plan over the period of disqualification, and hence taxable, years, if the plan had graded, or full vesting, and contributions were made. It would cause employees in such plans to include in income not only the current year's vested contributions but also the value of his vested interest in prior contributions to a disqualified plan that had become vested. For example, assume that a profit sharing plan is established in 1975, that a participant shall be vested at the rate of 20% for each year of service, that in each year from 1975 through 1979 inclusive, contributions are made and the amounts are allocated to the participant's separate accounts, and that the plan had been disqualified in all these years; the tax effects for a hypothetical participant would be as follows:

If an employee's *rights* in a trust which is exempt under section 501(a) are fully vested<sup>123</sup> at a time when such trust ceases to be so exempt, then such employee must include *the value of his interest in such trust* in his gross income as compensation for his taxable year which ends within or with the taxable year of the trust in which it ceases to be so exempt.

The proposed regulations do not define "rights";<sup>124</sup> however, the phrase "value of an employee's interest in a trust" is specifically defined as the amount of the employee's beneficial interest (whether or not

1	2	3	4	5	6	7
Year	Contribution Made in	% Vested	Account Balance Accumulated from Disqualified Contributions	Income From 2	Income From 4— Nonvested and Vested	Total Income Tax to Participant
1975	1000	20%	1000	200	—	200
1976	1500	40%	2500	600	500	1100
1977	1500	60%	4000	900	800	1700
1978	1500	80%	5500	1200	1100	2300
1979	2000	100%	7500	2000	1500	3500
	—		—			—
	7500					8800

This proposed regulation works properly in a situation similar to that in *Burnetta v. Commissioner*, 68 T.C. 387 (1977). In *Burnetta*, the defined contribution plans provided that a participant would be fully vested after two years of participation. The plans were initially adopted in 1970, but were disqualified from the outset because they failed to satisfy the coverage requirements. In 1970 and 1971 the IRS disallowed the corporation's deduction for its contribution to the plan and *Burnetta*, the only participant, did not realize income from these contributions. In 1972, the corporation again made a contribution. Because *Burnetta* was fully vested in 1972, the corporation finally received a deduction for its 1970, 1971, and 1972 contributions, and *Burnetta* recognized income from all prior years' contributions in one year. The IRS treated the trust as a separate taxpayer for each year it was disqualified, and thus it had to pay taxes on its earnings.

123. Prop. Reg. § 1.402(b)-1(b)(4)(1971) addresses the question of partial vesting, but apparently only in the context of the sentence (and principle) reviewed in note 122 *supra*. The proposed regulation provides, in pertinent part:

If, during any taxable year of an employee, only part of his rights under an employee's trust which is *not* exempt under section 501 (a) changes from non-vested to vested, then only the corresponding part of the value of the employee's interest in such trust is includible in the employee's gross income for such taxable year. (emphasis added).

This regulation leaves unresolved the interesting issue, under the proposed regulation cited in the text, whether a *partially* vested participant in a *disqualified* plan would have to include his previously vested value in his income, upon disqualification of the plan.

124. The phrase "rights" appears throughout the proposed regulation to I.R.C. § 402(b), but does not appear in the statute. The phrase, however, may simply mean "benefits."

vested) in the "net fair market value"<sup>125</sup> of all the assets in such trust as of the day such employee's interest in the trust changes from nonvested to vested.<sup>126</sup> The apparent authority for this part of the proposed regulation is the caveat in section 402(b) that "the value of the employee's interest in the trust shall be substituted for the fair market value of the property for the purposes of applying" section 83 to section 402(b).<sup>127</sup>

A strict application of this proposed regulation can be illustrated by an example:

Assume a profit sharing plan was established by a corporate employer in 1970. The plan provides for eligibility after two years of service, full vesting,<sup>128</sup> and contains no forfeiture-type clauses. Both the employer and the plan are on a calendar year basis for federal income tax purposes. There is no plan contribution made in or for 1976. In 1976, the plan becomes disqualified. The full account balance of each plan participant would, under the proposed regulations, be included in the income of each participant for 1976.<sup>129</sup>

Where a participant would be charged income based upon a prior year's contribution to a plan that has lost its qualified status, the result suggested by the second subsection of the proposed regulations is overstated. Section 402(b) addresses only "*contributions*"<sup>130</sup> to an employees' trust . . . which ends within or with a *taxable year* of the trust for which the trust is *not exempt from tax* under section 501(a)." Accordingly, the reference in 402(b) to section 83, as well as the caveat in section 402(b) which substitutes the phrase "value of employee's interest" for section

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125. Prop. Reg. § 1.402(b)-1(b)(2) (1971) states as follows:

The net fair market value of all the assets in a trust is the total amount of the fair market values . . . of all the assets in the trust less the amount of all the liabilities (including taxes) to which such assets are subject or which such trust has assumed (other than the rights of any employee in such assets), as of any day when an employee's interest in such trust changes from nonvested to vested.

126. See *id.* § 1.402(b)-1(b)(2).

127. See I.R.C. § 402(b); text accompanying note 95 *supra*.

128. Under ERISA, plans that require more than a one year eligibility period must provide full and immediate vesting. See I.R.C. § 410(a)(1)(B)(i).

129. This tax result occurs regardless of how or why the plan became disqualified, and of the resulting hardship on the employees. In addition to those hardships noted in note 119 *supra*, the trust would be subject to income tax liability, see notes 157-73 *infra*, and accompanying text, which would obviously reduce the trust's assets and, consequently, the amounts available to the participants.

130. It is interesting to note that the statutory phrase in I.R.C. § 402(b) is "[c]ontributions," in the plural, while the language it refers to is for "*a taxable year*," in the singular. The use of the plural is not a basis for aggregating several years of contributions, but rather can be read to refer to a series of timely made contributions within one year for the benefit of all employees. (emphasis added).

83's "fair market value of the property" must be similarly interpreted, limited, understood, and applied. Thus, section 83's application within section 402(b), which determines the income inclusion of the participants in a disqualified plan, is limited only to the *contribution(s) made during the year(s) which the trust was not exempt*. The phrase "value of an interest" in section 402(b) should not include any contributions made to a plan in a year(s) other than the year(s) in which the trust was *not* exempt under section 501(a).<sup>131</sup>

This interpretation of section 402(b) is consistent with the basic tenet of pension plan law that the qualified status of a plan is to be determined on a yearly basis.<sup>132</sup> It also parallels the language of the regulations which provide:

[a]n employer makes a *contribution* for the benefit of an employee to a trust described in section 401(a) for the taxable year of the employer which ends within or with a taxable year of the trust for which the trust *is exempt* under section 501(a), the employee is *not* required to include such contribution in his income.<sup>133</sup>

Furthermore, as a matter of equity, an interpretation that limits the income attributable to an employee to the contribution(s) for each year(s) the plan is disqualified, encourages a plan to requalify without financially debilitating either the plan or its participants. Finally, this interpretation of section 402(b) is consistent with the third sentence of section 402(b) which states that income earned in a nonexempt trust shall *not* be charged to the participants. Despite this statutory provision, the Commissioner has interpreted the "value of an employee's interest" in a defined contribution plan to include income realized over the entire term of the employee's participation in the plan as reflected in his account balance at the time of the plan's disqualification.

It is submitted, based on the above analysis, that when a qualified plan loses its qualified status a participant will realize income only to the extent of his vested contribution made to the plan during its disqualified tax year. This result is contrary to the proposed regulation's position which treats the full previously accrued account balance as realized

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131. Similarly, the change of a participant's interest from partially (or wholly) nonvested to vested would be limited to the vested value attributable to the contribution made in a year the plan was not qualified and the trust not exempt. *See, e.g.*, note 122 *supra*. This interpretation would prevent an inequitable bunching of income from prior years' contributions when a qualified plan first loses its qualified status.

132. *See* note 13 *supra* and accompanying text.

133. Treas. Reg. § 1.402(a)-1(a)(1)(i), T.D. 6203, 1956-2 C.B. 234 (emphasis added).

income, but is the result recently reached, without analysis, by the Tax Court in *Feroletto Steel Co. v. Commissioner*.<sup>134</sup>

(ii) *Second Sentence of Section 402(b)*

The meaning of the second sentence of section 402(b) turns on the phrases “actually distributed” and “made available:” “actually distributed” concerns the actual receipt of funds whereas “made available” deals with constructive receipt. Although neither the current nor the proposed regulations to section 402(b) discuss the meaning of “made available,” section 402(a)(2) incorporates this language. Revenue Ruling 55-423<sup>135</sup> concerns section 402(a)(2) and provides some guidance:

A participant's interest in such a [qualified] trust is not made available to him unless and until it is unconditionally credited to or set apart for him and made subject to his withdrawal or other disposition. Conditions upon such withdrawal or disposition which are without substance however, are not deemed to prevent the participant's interest from being made available. . . . Most cases in which the issue arises as to whether a participant's interest has been made available fall into two general classes, namely, (1) penalties for withdrawal, and (2) a prior irrevocable election to defer distribution to a fixed or determinable future time.<sup>136</sup>

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134. 69 T.C. —, [1977] TAX CT. REP. (CCH) Dec. 34,610. The Research Institute of America, in its January 19, 1978, Weekly Alert, indicated that the final regulations (presumably under I.R.C. § 402) may give employees of disqualified plans some relief by not taxing them immediately on employer contributions that vest in them.

135. 1955-1 C.B. 41. *See also* *Leavens v. Commissioner*, 467 F.2d 809 (3d Cir. 1972).

136. The revenue ruling continues:

In the penalty type of case a participant, who makes a withdrawal, is required to discontinue his participation in the trust or suffer a forfeiture with respect to a portion of his distributable interest. Discontinuance of participation is the surrender of a valuable right and, as long as that remains a condition for withdrawal of his interest, such interest is not made available to the participant.

Another example of a penalty type of case is a six month suspension of participation. *See* Rev. Rul. 58-230, 1958-1 C.B. 204.

Revenue Ruling 55-423 also states:

In the deferment by prior election type of case, if the trust indenture, or the plan of which it is a part, provides for an irrevocable election by the employee prior to the time his interest becomes distributable to him to have distribution of such interest deferred to a fixed or determinable future time, such as ten years or upon his prior retirement, severance of employment, death, or disability, his interest is not made available prior to such time or occurrence of any of the events enumerated. So long as an employee's election to defer the actual receipt is irrevocable, it is immaterial whether the exercise thereof takes the form of positive action or merely inaction on the part of the employee.

In both situations, the conditions must be consequential and of substance to prevent constructive receipt. Another means of preventing employer contributions from being “made available” on withdrawal is to interpose an administrative committee which must approve financial need in order to disburse funds. *See* Rev. Rul. 71-332, 1971-2 C.B. 210; Rev. Rul. 55-424, 1955-1 C.B. 42.

If a plan is disqualified and funds are either "made available" or "actually distributed" to plan participants, they would be subject to taxation under the second sentence of section 402(b).<sup>137</sup> Two cases consider the question of "how much" taxation will result.

In *Greenwald v. Commissioner*,<sup>138</sup> Interstate Hosiery Mill, Inc., established a profit sharing plan for its employees which received IRS approval in May, 1945.<sup>139</sup> In 1953, the assets of Interstate were acquired by another company, and fifty-nine of sixty plan participants left the employ of Interstate.<sup>140</sup> Only Mr. Greenwald remained with the company and a participant in the plan. In 1954, the fifty-nine participants received their full distribution from the plan; at that time, Mr. Greenwald had \$90,281.08 in his account.<sup>141</sup> Interstate became an investment corporation and remained in business until 1959, when it sold its assets. No contributions were made to the plan from 1954 through 1959. The plan was terminated in 1959, and Mr. Greenwald received cash and property valued at \$168,922.55, which he reported as capital gains in his 1959 income tax return.

The Commissioner argued that because the plan was not qualified,<sup>142</sup> the distribution to Mr. Greenwald was from a disqualified plan, and was to be taxed at ordinary income rates. The Second Circuit agreed that the plan was not qualified after 1954, but held the amount in Greenwald's account as of 1954 (\$90,281.08) was only subject to taxation at capital gain rates. The court reasoned that the other employees had "most probably received capital gains treatment as to the amounts distributed to them. It would be harsh to treat the taxpayer differently, merely because he stayed on with the same employer after the radical transformation of its business."<sup>143</sup> In support of its decision, the court explained:

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137. Three additional notes are necessary: If income had been realized from prior I.R.C. § 402(b) applications, the participants would be credited with basis in the amount of the prior income recognized. Second, the application of the second sentence is intertwined with I.R.C. § 72. Third, income averaging is available. See I.R.C. §§ 1301-1305.

138. 366 F.2d 538 (2d Cir. 1966).

139. Between 1945 and 1953, the plan made several amendments, all of which received IRS approval. *Id.* at 539.

140. This presumably was treated as a partial termination. See Rev. Rul. 73-284, 1973-2 C.B. 139.

141. 366 F.2d at 539.

142. The Commissioner argued that because the plan covered only one employee, it had become discriminatory in its operation. This argument, resisted vigorously by the taxpayer, was accepted by the Second Circuit. Today, however, a one-man plan may be permissible, even if the participant is the sole shareholder, highest paid employee, or officer.

143. 366 F.2d at 541.

Nor is such harshness required by the statute. Section 402(a)(2) affords capital gains treatment to distributions payable "in the case of" exempt trusts. Section 402(b) provides that distributions distributed or made available . . . should be taxable as ordinary income. There is no reason in the statute or elsewhere why we should not consider that portion of the 1959 distribution equivalent to the amount standing to taxpayer's credit in the profit-sharing trust before it became discriminatory in operation, as a distribution from an exempt trust, and so entitled to capital gains treatment. The remainder of the 1959 distribution represents a distribution from a discriminatory trust, and so is properly includible in taxpayer's 1959 income at ordinary income rates. Such a result seems consistent with the underlying purpose of the statute, since it affords capital gains treatment only so long as a profit-sharing trust remains nondiscriminatory in operation. Moreover, the result gains support in the language of § 402(b), which envisages a year by year consideration of whether or not a profit-sharing trust is tax-exempt.<sup>144</sup>

*Pitt v. United States*<sup>145</sup> followed *Greenwald*. In 1959, the Florida Machine Products Company established a qualified profit sharing plan. Because of certain prohibited transactions,<sup>146</sup> however, the plan lost its qualified status in 1969. Upon termination in 1970, the plan requested a determination letter. The IRS concluded that the trust associated with this plan was not exempt, and the long term capital gains provisions of section 402(a)(2) were not applicable. Pitt received \$17,605.44 from the plan upon its termination, which he reported on his 1970 income tax return as a capital gain. The district court accepted the conclusion that the plan had not regained its qualified status in 1970, the year of the distribution. The issue before the court, however, was whether the IRS "properly denied capital gains treatment to the entire amount of the distribution."<sup>147</sup> The Commissioner argued that the entire distribution to Pitt was taxable at ordinary income rates because it was received after the trust lost its tax exempt status. The taxpayer, on the other hand, claimed that only the amount *contributed* to the plan after revocation of its tax exempt status was subject to taxation at ordinary income rates. The court, relying on *Greenwald*, held that Pitt was entitled to capital gains treatment on the amount of the distribution that was contributed while the

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144. *Id.*

145. 75-1 U.S. Tax Cas. 87,244 (M.D. Fla. 1975).

146. A plan cannot be disqualified for engaging in prohibited transactions under ERISA; such transactions are subject to excise taxes. See I.R.C. § 4975.

147. 75-1 U.S. Tax Cas. at 87,244.

plan's trust was exempt and that the balance of the distribution, which resulted from contributions made after the plan was disqualified, was subject to taxation at ordinary income rates.

These cases establish that, with respect to the amounts actually distributed from a disqualified plan, the participant could receive "credit" for the contribution and increments made while the plan was qualified. The amount so "credited" to him would be the account balance or accrued benefit as of the last date of the plan's qualification. This may enable a participant to claim the benefits of capital gains treatment on at least part of his distribution. Under ERISA, although capital gains treatment still exists,<sup>148</sup> the lump sum distribution rules<sup>149</sup> may yield more favorable tax results than capital gains treatment. A taxpayer relying on *Greenwald* and *Pitt* should be able to argue for lump sum distribution treatment or that portion of the distribution from a disqualified plan attributable to the plan's qualified years while accepting regular, ordinary income treatment on the balance of such a distribution.

(iii) *Third Sentence of Section 402(b)*

The third sentence of section 402(b) provides that participants in disqualified plans will not be treated as owners of the trust in issue, and therefore will not be charged with income from the trust's earnings. The trust, as a separate taxpayer, will bear the income tax burden on its earnings.

B. *Effects on the Employer*

An employer's contributions to a qualified plan are deductible within the limits set forth in section 404(a)(1),(2), and (3).<sup>150</sup> Section 404(a)(5) provides that contributions to nonqualified plans are also deductible "in the taxable year in which an amount attributable to the contribution is includible in the gross income of employees participating in the plan, but, in the case of a plan in which more than one employee participates only if separate accounts are maintained for each employee."<sup>151</sup> Under

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148. See I.R.C. § 402(a)(2).

149. See I.R.C. §§ 402, 4972. Query: if tax treatment can be split, can the amount attributable to the qualified plan portion of a split distribution be "rolled over" under I.R.C. § 402(a)(5)?

150. I.R.C. § 404(a) also refers to the I.R.C. § 162 and I.R.C. § 212 requirements to sustain a deduction.

151. The existing regulations to I.R.C. § 404(a)(5) are not helpful for the post-1969 period because they do not reflect the amendment to I.R.C. § 402(b). This regulation, Treas. Reg. § 1.404(a)-(12) (1956), is based on the concept of "nonforfeitability" as

this provision, an employer who makes contributions to a plan that becomes disqualified will generally be allowed a deduction only in a defined contribution plan and then only to the extent the employees recognize income under section 402(b).<sup>152</sup> If the plan is a defined benefit plan with more than one employee, a deduction probably<sup>153</sup> would not be allowed because separate accounts are not maintained.

The second impact on the disqualified plan's sponsoring employer is a potential liability for FICA and FUTA taxes.<sup>154</sup> Although qualified plans are clearly exempt from such tax liability,<sup>155</sup> the Code and regulations are silent with respect to the proper withholding tax treatment of contributions to disqualified plans.<sup>156</sup>

### C. *Effects on the Trust*

A trust<sup>157</sup> is exempt from taxation under section 501(a) only as long as the plan, which is part of the trust, is qualified under section 401(a);

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defined in Treas. Reg. § 1.402(b)-1(a)(2)(i), T.D. 6783, 1965-1 C.B.180. A proposed regulation, Prop. Reg. § 1.404(a)-(12), was issued in June, 1971, but has not become permanent.

152. The employer may take as a deduction amounts contributed to a defined contribution plan despite the exclusion provided in I.R.C. § 101(b). See Prop. Reg. § 1.404(a)-(12)(b)(1) (1971). The proposed regulations do not resolve the issue of whether an employer may deduct the trust earnings which are includible in the employee's income under I.R.C. § 404(a)(5). When a participant recognizes income under the second sentence of I.R.C. § 402(b) because of a distribution from a disqualified plan, the amount may include trust earnings (or losses). The question then is whether those trust earnings constitute "an amount *attributable* to the contribution . . . includible in the gross income of" an employee for deduction purposes by an employer under I.R.C. § 404(a)(5) (emphasis added).

153. Under some actuarially sound funding methods—*i.e.*, a level premium insured account plan—separate accounts are maintained in defined benefit plans, which would entitle the employer to a deduction as set forth in I.R.C. § 404(a)(5). If this type of plan funding is not used, the deduction for contributions to a defined benefit plan may be lost. But even in this situation, the participant in a defined benefit plan will recognize income to the extent he is vested. See notes 115-19 *supra* and accompanying text.

154. See I.R.C. §§ 3121, 3306.

155. *Id.* §§ 3121(a)(5), 3306(b)(5).

156. In this context, it is interesting to note that the proposed regulations under I.R.C. § 402(b) discuss the tax treatment to the participants as "compensation." Prop. Reg. § 1.402(b)-1(a)(1)(1971). See generally Simmons, *supra* note 60, at 538-43.

157. I.R.C. § 501 provides an automatic tax exemption for a trust qualified under I.R.C. § 401(a). Subsection (a) of I.R.C. § 501 provides, in pertinent part: "An organization described in . . . section 401(a) shall be exempt from taxation under this subtitle . . . ." It must be noted that the applicable estate tax exemption, see I.R.C. § 2039(c), also applies only to qualified plans, and would be unavailable to benefits from a disqualified plan. If the plan is operated without a trust, because the assets of the plan are invested with an insurance company, I.R.C. § 501(a) is applicable. See I.R.M. Audit 45(10) 5-2 § 713.2.

when a plan becomes disqualified, the trust loses its exempt status and is taxable under section 641. Unlike trusts intended to be taxable and, consequently, drafted for maximum tax advantage, the plan which becomes disqualified, and the nonexempt trust associated with it, did not anticipate federal income taxation, and thus are unable to avoid maximum tax liability.

A disqualified plan's trust must file a federal income tax return<sup>158</sup> because it is a separate taxable entity.<sup>159</sup> In fact, the IRS Audit Manual provides<sup>160</sup> that even if an employer contests the IRS's decision to revoke the qualified status of the plan, the examining IRS agent must prepare the trust's tax returns. The income of such a trust is recognized to the extent it is realized under the trust's regular method of accounting. Income subject to such recognition includes all interest, dividends, and capital asset transactions.<sup>161</sup> Unrealized appreciation or depreciation is not recognized for tax purposes nor—and this is crucial—are employer contributions recognized as income to the trust.<sup>162</sup>

After the gross income of a disqualified plan's taxable trust has been determined, the distributable net income<sup>163</sup> of that trust must be calculated. Although most taxable trusts receive credit for distributions to participants when calculating the distributable net income,<sup>164</sup> a special problem is created for the trust of a disqualified plan.

In accordance with Revenue Ruling 74-299,<sup>165</sup> section 661(a) allows a disqualified plan a deduction for distributions to terminating participants when computing its taxable income subject to the separate share rule of section 663.<sup>166</sup> The separate share rule, as applied to a trust of a disqualified plan that has more than one beneficiary, means that each beneficiary's share (account) is to be treated as a separate trust for the plan trust's calculation of distributable net income. Revenue Ruling 74-299 specifically states that the provisions of section 402(b) take precedence

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158. The present form is Form 1041. A return must be filed if the trust had taxable income, gross income in excess of \$600, or a beneficiary who is a nonresident alien. *See* Treas. Reg. § 1.6012-3(a), T.D. 7407, 1976-1 C.B. 353.

159. As a separate taxable entity, the trust of a disqualified plan has the same right to appeal as do all other taxpayers. *See* note 89 *supra*.

160. *See* I.R.M.-Audit 45(10) 5-2 § 713.1.

161. *See* Treas. Reg. § 1.641(a)-2 (1956).

162. *Cf.* I.R.C. § 158 (contribution to qualified homeowners association exempt from tax).

163. *See* I.R.C. § 643(a).

164. *Id.* § 661(a).

165. 1974-1 C.B. 154.

166. *See* Treas. Reg. § 1.663(c)-1(a) (1956).

over section 662(a). Thus, the deduction allowed a disqualified plan's trust under section 661(a) is limited to the distributees' separate shares of the distributable net income.

To illustrate these rules, assume that a qualified, defined contribution plan becomes disqualified and accordingly the plan's trust loses its exempt status. Assume also that the trust makes a \$15,000 distribution to one terminated participant in the taxable year, that the trust has \$50,000 in taxable income, and that the terminated participant had \$3,000 of the taxable income allocated to his individual account in the year of distribution.<sup>167</sup> Under section 661(a) the trust in this hypothetical is entitled to only a \$3,000 deduction (not the \$15,000 distribution) when computing its net taxable income.

In addition to the separate share rule of Revenue Ruling 74-299, the trust of a disqualified plan is entitled to the same ordinary and necessary deductions for business expenses that individuals are allowed.<sup>168</sup> These may consist of interest expenses, legal expenses, actuarial fees, trustee fees, administrative expenses, and depreciation. Finally, such a trust, because it is a complex trust,<sup>169</sup> is entitled to an exemption of \$100 per year.<sup>170</sup>

A second effect on the trust associated with a disqualified plan concerns the proper treatment of withholding taxes.<sup>171</sup> Section 3401(a)(12) specifically exempts from wages contributions to, or distributions from, qualified plans. Again, the Code and regulations are silent with respect to trusts of disqualified plans. The regulations,<sup>172</sup> however, provide that nonannuity distributions from pension or retirement pay are subject to

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167. Revenue Ruling 74-299 and the regulations under I.R.C. § 641 squarely address the income taxation of a trust of a disqualified defined benefit plan, since such plans generally do not have separate participant shares or accounts.

168. See Treas. Reg. § 1.641(b)-1 (1956).

169. *Id.* § 1.651(a)-1.

170. *Id.* § 1.642(b)-1. In addition, such trusts are entitled to the dividend exclusion. See Treas. Reg. § 1.116-1, T.D. 7332, 1975-1 C.B. 204.

Because of the nature of the disqualification process, the final determination that a plan has lost its qualified status will inevitably be made long after the plan year is closed. Once the trust of a disqualified plan becomes subject to income taxation, it will owe interest on any taxes not timely paid. Nevertheless, delinquency penalties will generally not be assessed if the required informational returns of a qualified plan and trust were otherwise timely filed.

171. See I.R.C. § 3401.

172. See Treas. Reg. § 31.3401(a)-1(b)(1)(i), T.D. 6259, 1957-2 C.B. 645. After determining the gross income and all applicable deductions, credits, and exemptions, the trust of a disqualified plan is taxed according to I.R.C. § 1(a).

withholding taxes. The probable result will be that withholding tax liability will parallel the income tax liability of the participants under section 402(b); thus, if the participant in a disqualified plan recognizes income under section 402(b), the trustee of the trust associated with a disqualified plan may be subject to withholding tax liability to the extent of the income so recognized.<sup>173</sup>

#### V. CONCLUSION

Because of the numerous and drastic tax consequences associated with the disqualification of a qualified pension plan, the best "defense" is a constant and careful self-review to ensure its continued qualified status.

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173. See Simmons, *supra* note 60, at 538-39. For a discussion of tax liability on distributions from disqualified plans, see *id.* at 538-43.