

Revenue Ruling **92-76**  
Internal Revenue Service  
1992-2 C.B. 76

*26 CFR 1.401(a)(4)-5: Plan amendments and plan terminations.  
(Also Section 402.)*

**Pre-termination restrictions; plan qualifications.** Guidance is provided to implement section 1.401(a)(4)-5(b) of the regulations which replaces section 1.401-4(c) pertaining to the early termination restrictions and the 25 most highly compensated employees (including former employees) of an employer. Rev. Rul. 81-135 obsoleted.

**Rev. Rul. 92-76**

**PURPOSE**

The purpose of this revenue ruling is to provide guidance for employers to implement section 1.401(a)(4)-5(b) of the Income Tax Regulations, which replaces section 1.401-4(c) of the regulations. This revenue ruling obsoletes Rev. Rul. 81-135, 1981-1 C.B. 203.

**ISSUES**

(1) Whether the described plan amendment satisfies the pre-termination restrictions of section 1.401(a)(4)-5(b) of the regulations.

(2) Whether a distribution that is otherwise a lump sum distribution under section 402(e)(4)(A) of the Internal Revenue Code, but which is subject to the escrow agreement described below, constitutes a lump sum distribution.

**FACTS**

An employer established a defined benefit plan for the benefit of its employees, effective January 1, 1985. The plan contained provisions restricting benefits in accordance with the requirements of section 1.401-4(c) of the regulations, including descriptions of the employees whose benefits were restricted. The plan was amended in 1992 in order to change the provisions to restrict benefits in accordance with the requirements of section 1.401(a)(4)-5(b). The amended plan provisions identify the employees who are affected by the restrictions and provides for all of the exceptions permitted by the regulations. The affected employees are the 25 highly compensated employees or highly compensated former employees of the employer who have the greatest compensation from the employer in the current or any prior plan year ("top 25 highly compensated employees").

As amended, the plan provides that the application of the new rules under section 1.401(a)(4)-5(b) of the regulations shall be effective for all distributions commencing in a plan year beginning on or after January 1, 1994, which is the first plan year that the regulations under

section 401(a)(4) of the Code are effective for this plan. The plan permits distributions of amounts in excess of the limits of section 1.401(a)(4)-5(b)(3)(i), provided that an agreement has been established to secure repayment to the plan of any amount necessary for the distribution of assets upon plan termination to satisfy section 401(a)(4).

During a plan year, the amount that may be required to be repaid to the plan is the restricted amount. The restricted amount is the excess of the accumulated amount of distributions made to the employee over the accumulated amount of the employee's nonrestricted limit. The employee's nonrestricted limit is equal to the payments that could have been distributed to the employee, commencing when distribution commenced to the employee, had the employee received payments in the form described in section 1.401(a)(4)-5(b)(3)(i)(A) and (B) of the regulations. An "accumulated amount" is the amount of a payment increased by a reasonable amount of interest from the date the payment was made (or would have been made) until the date for the determination of the restricted amount.

In order to secure an employee's repayment obligation of the restricted amount, the plan provides that prior to receipt of a distribution an employee must agree that upon distribution the employee will promptly deposit in escrow with an acceptable depository property having a fair market value equal to at least 125 percent of the restricted amount. The plan also provides that the obligation of an employee under the repayment agreement alternatively can be secured or collateralized by posting a bond equal to at least 100 percent of the restricted amount. For this purpose, the bond must be furnished by an insurance company, bonding company or other surety approved by the U.S. Treasury Department as an acceptable surety for federal bonds. The plan also provides that an employee's obligation under the repayment agreement can be secured by a bank letter of credit in an amount equal to at least 100 percent of the restricted amount.

The plan provides that amounts in the escrow account in excess of 125 percent of the restricted amount may be withdrawn for the employee. Similar rules apply to the release of any liability in excess of 100 percent of the restricted amount where the repayment obligation has been secured by a bond or a letter of credit. The plan further provides that if the market value of the property in the escrow account falls below 110 percent of the restricted amount, the employee is obligated to deposit additional property to bring the value of the property held by the depository up to 125 percent of the restricted amount. In addition, the plan provides that an employee has the right to receive any income from the property placed in escrow, subject to the obligation to maintain the value of the property as described.

A depository may not redeliver to an employee any property held under an agreement, other than amounts in excess of 125 percent of the restricted amount, and a surety or bank may not release any liability on a bond or letter of credit unless the plan administrator certifies to the depository, surety or bank that the employee (or the employee's estate) is no longer obligated to repay any amount under the agreement. The plan provides that the plan administrator will make such a certification if at any time after the distribution commences either (1) the value of plan assets equals or exceeds 110 percent of the value of current liabilities; or (2) the value of the employee's future nonrestricted limit constitutes less than 1 percent of the value of current liabilities; or (3) the value of the employee's future nonrestricted limit does not exceed \$3,500; or (4) the plan has terminated and the benefit received by the employee is nondiscriminatory. Such

a certification by the plan administrator terminates the agreement between the employee and the plan administrator.

As amended, the plan provides separate rules for distributions commencing in a plan year beginning prior to January 1, 1994, that are restricted in accordance with section 1.401-4(c) of the regulations. The plan amendment provides that the plan provisions imposing restrictions in accordance with section 1.401-4(c) (and any corresponding escrow arrangements) will continue to apply only if the distributions also would be restricted under the plan provisions implementing section 1.401(a)(4)-5(b). Thus, an existing escrow arrangement will be terminated if the plan administrator makes one of the above certifications, including a certification that the employee is not one of the top 25 highly compensated employees.

Employee A, one of the top 25 highly compensated employees of the employer, separates from service with the employer in the plan year beginning on January 1, 1994, when the value of plan assets equals less than 110 percent of the value of current liabilities. Also, the value of the single-sum distribution of A's benefits under the plan is more than 1 percent of the value of the plan's current liabilities, and the value of A's benefits exceeds \$3,500. Upon separating from service, within the meaning of section 402(e)(4)(A) of the Code, A receives a single-sum distribution of A's total accrued benefit. Prior to the distribution A executes a repayment agreement in accordance with the plan provision for escrow arrangements. A's distribution will be subject to the plan's provisions that restrict distributions in accordance with section 1.401(a)(4)-5(b) of the regulations. Thus, A's escrow arrangement will continue until (pursuant to the plan provisions) the plan administrator makes one of the certifications described above to release the escrow.

Employee B, one of the employees of the employer who was subject to the plan's provisions that implement the restrictions in section 1.401-4(c) of the regulations, separated from service with the employer in the plan year beginning on January 1, 1988. Upon separating from service, within the meaning of section 402(e)(4)(A) of the Code, B received a single-sum distribution of B's total accrued benefit. Prior to the distribution, B executed a repayment agreement that established an escrow arrangement to guarantee the repayment to the plan of any amount required for the plan to satisfy section 1.401-4(c). In 1992, the plan administrator certifies that B is not one of the top 25 highly compensated employees, and therefore is not subject to the restrictions on plan distributions under the plan amendment. Consequently, the amount in escrow for B may be released.

Employee C, one of the employees of the employer who was subject to the plan's provisions that implement the restrictions in section 1.401-4(c) of the regulations and one of the top 25 highly compensated employees of the employer, separated from service with the employer in the plan year beginning on January 1, 1988. Upon separating from service, within the meaning of section 402(e)(4)(A) of the Code, C received a single-sum distribution of C's total accrued benefit. Prior to the distribution, C executed a repayment agreement that established an escrow arrangement to guarantee the repayment to the plan of any amount required for the plan to satisfy section 1.401-4(c). In 1992, the value of plan assets is less than 110 percent of the value of current liabilities; the value of C's future nonrestricted limit is more than 1 percent of the value of the plan's current liabilities; and the value of C's future nonrestricted limit exceeds \$3,500. As provided in the amendment to the plan, C's distribution continues to be subject to the restrictions

in accordance with section 1.401-4(c) because it also would be restricted if the plan provision implementing section 1.401(a)(4)-5(b) were applied. Thus, the escrow arrangement of C will continue for the time period required to satisfy section 1.401-4(c), or until the plan administrator makes one of the certifications described above to release the escrow, pursuant to the plan provisions.

## LAW AND ANALYSIS (ISSUE 1)

Section 1.401(a)(4)-5(b)(1) of the regulations provides that a pension plan qualified under section 401(a) of the Code must expressly incorporate provisions that comply with section 1.401(a)(4)-5(b)(2) and (3) at the time the plan is established, or, if later, as of the effective date of these regulations, unless the Commissioner determines that such provisions are not necessary to prevent the prohibited discrimination that may occur in the event of an early termination of the plan.

For distributions that commence in plan years beginning prior to the effective date under section 1.401(a)(4)-13 of the regulations, a plan may be amended to provide that either the restrictions under section 1.401-4(c) or the restrictions under section 1.401(a)(4)-5(b) will apply to particular groups of employees, provided that the amendment is not discriminatory with respect to nonhighly compensated employees whose benefits are restricted under section 1.401-4(c). Under these circumstances, an employer may either retain the existing restrictions and escrows or amend the plan to remove the restrictions and release the escrows for plan distributions that were restricted pursuant to section 1.401-4(c), but that would no longer be restricted under the rules of section 1.401(a)(4)-5(b).

Section 1.401(a)(4)-5(b)(3) of the regulations requires that limits be placed on plan distributions to highly compensated employees and highly compensated former employees. Under these regulations, in any one year the number of employees subject to the restrictions can be limited to not less than 25 highly compensated employees and highly compensated former employees. If this group is so limited, it must include the highly compensated employees and highly compensated former employees who have the greatest compensation in the current or any prior plan year. The regulations limit each annual payment made to an amount equal to the payments that would be made on behalf of the employee under the following:

(A) A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the employee is entitled under the plan (other than a social security supplement), plus

(B) The amount of the payments that the employee is entitled to receive under a social security supplement.

The limits apply unless (1) after payment to the employee of all benefits (as defined by section 1.401(a)(4)-5(b) of the regulations), the value of plan assets equals or exceeds 110 percent of the value of current liabilities; or (2) the value of benefits payable to the employee is less than 1 percent of the value of current liabilities before distribution; or (3) the value of the benefits payable to the employee does not exceed the amount described in section 411(a)(11)(A) of the

Code (\$3,500); or (4) the plan terminates and the benefit received by the employee is nondiscriminatory under section 401(a)(4).

For plan years beginning prior to the effective date under section 1.401(a)(4)-13 of the regulations, section 1.401-4(c) provides restrictions on the amount of employer contributions that can be used to provide benefits to certain employees. These regulations provide that the restrictions would apply for a period of at least ten years following the establishment of a plan or an amendment to a plan that substantially increases the extent of possible discrimination as to contributions or benefits actually payable in the event of plan termination.

The application of section 1.401-4(c) of the regulations permits plan distributions in excess of the limits of that section, provided certain requirements are met. In a similar manner, a plan distribution that would otherwise exceed the restrictions of section 1.401(a)(4)-5(b) may be made, provided that the plan requires adequate security to guarantee any repayment of the restricted amount upon plan termination. For this purpose, the restricted amount is the excess of the accumulated amount of distributions to an employee over the accumulated amount of the payments that would have been paid under: (A) A straight life annuity that is the actuarial equivalent of the accrued benefit and other benefits to which the employee is entitled under the plan (other than a social security supplement), plus (B) The amount of the payments that the employee is entitled to receive under a social security supplement. An "accumulated amount" is the amount of a payment increased by a reasonable amount of interest from the date the payment was made (or would have been made) until the date for the determination of the restricted amount.

As amended, the plan will not violate the restrictions contained in section 1.401(a)(4)-5(b) of the regulations by allowing the payment of restricted amounts because the plan includes adequate provisions to secure any necessary repayment in the event of a plan termination. The plan provisions are adequate because, upon receipt of a distribution from the plan, the employee deposits in escrow property having a fair market value equal to at least 125 percent of the restricted amount or, in the alternative, posts a bond or letter of credit in an amount equal to at least 100 percent of the restricted amount.

The plan also will not violate the provisions of section 1.401(a)(4)-5(b) of the regulations by providing that distributions that are made or commenced prior to the effective date of the section 401(a)(4) regulations for the plan and that are restricted under section 1.401-4(c) will not continue to be restricted unless the distributions also would be restricted under the rules of section 1.401(a)(4)-5(b). Under the facts of this revenue ruling, the restrictions under section 1.401-4(c) could have been retained for all earlier distributions that were restricted under those provisions, but the employer, instead, chose to amend the plan to allow for the release of those distributions if they would not be restricted under the rules in section 1.401(a)(4)-5(b), and to allow for the retention of the restrictions in accordance with section 1.401-4(c) for those distributions that would remain restricted if the new rules were applied. Therefore, for distributions before the effective date of the regulations, an employee can receive a distribution of an amount in escrow if the amount could be released under either section 1.401-4(c) or section 1.401(a)(4)-5(b). Under these facts, the application of the old and new rules under the plan is

nondiscriminatory because the restrictions are retained for only the top 25 highly compensated employees.

Section 1.411(d)-4, Q & A-2(b)(1) of the regulations provides, in relevant part, that the Commissioner may provide for the elimination or reduction of section 411(d)(6) protected benefits that have already accrued, but only to the extent such elimination or reduction is necessary to permit compliance with the other requirements of section 401(a) of the Code, such as the nondiscrimination rules of section 401(a)(4). Pursuant to the authority granted in these regulations, the amendment of a plan to replace plan provisions that complied with section 1.401-4(c) with provisions that comply with section 1.401(a)(4)-5(b) is not deemed to be a violation of section 411(d)(6).

#### HOLDING (ISSUE 1)

The amendment to the plan, as described above, and the operation of the plan in accordance with its terms satisfy the requirements of section 1.401(a)(4)-5(b) of the regulations. Therefore, the distributions in connection with escrow arrangements do not cause the plan to fail to satisfy section 401(a) of the Code.

#### EXTENDED PERIOD OF TIME TO AMEND

Amendments to comply with the requirements of section 1.401(a)(4)-5(b) of the regulations and this revenue ruling must generally be adopted by the end of the remedial amendment period in which qualified plans must be amended to comply with the Tax Reform Act of 1986 (TRA '86). (See Notice 92-36, page 364, this Bulletin). However, the adoption of plan language permitting distribution of restricted amounts, as provided above, may, in the situations described below, be deferred to a date later than the end of the TRA '86 remedial amendment period.

First, in accordance with section 17.03 of Rev. Proc. 89-9, 1989-1 C.B. 780, and section 15.02 of Rev. Proc. 89-13, 1989-1 C.B. 801, (relating to master and prototype and regional prototype plans, respectively) and Notice 90-73, 1990-2 C.B. 353, M&P and regional prototype plans that were submitted to the Service for opinion or notification letters under TRA '86 before April 1, 1991, are not required to be amended to permit distribution of restricted amounts, as described above, prior to the end of the extended reliance period for these plans. In addition, in the case of M&P and regional prototype plans submitted to the Service for opinion or notification letters under TRA '86 after March 31, 1991, but on or before November 20, 1992, an amendment to permit distribution of restricted amounts, as described above, shall not be required before the end of the extended reliance period for these plans. However, distributions of restricted amounts can be made only if, in operation, adequate security arrangements exist to guarantee compliance with section 1.401-4(c) or 1.401(a)(4)-5(b), respectively.

Second, any other plan that is submitted for a favorable determination letter under TRA '86 on or before November 20, 1992, will not be required to be amended again within the TRA '86 remedial amendment period solely to permit distribution of restricted amounts, as described above. In this circumstance, the amendment may be deferred until the earliest date following the end of the TRA '86 remedial amendment period on which the plan (a) is submitted to the Service

for a determination letter; (b) is required to be amended for regulations, other revenue rulings, revenue procedures or other releases issued after the date of the plan's original TRA '86 determination letter application; or (c) is otherwise required to be amended by subsequent legislation. However, distributions of restricted amounts can be made only if, in operation, adequate security arrangements exist to guarantee compliance with section 1.401-4(c) or 1.401(a)(4)-5(b), respectively.

#### LAW AND ANALYSIS (ISSUE 2)

Section 402(e)(4)(A) of the Code generally defines a lump sum distribution as payment within one taxable year of the balance to the credit of an employee on account of the employee's separation from service, death, becoming disabled or attaining age 59-1/2 .

Under the facts of this revenue ruling, the accrued benefits of A, B and C were paid on one day on account of the employees' separation from service. The accrued benefits equal the balance to the credit of A, B and C. That certain amounts may have to be repaid at a future date, in accordance with the terms of the escrow arrangement, does not affect the conclusion that A, B and C have received the balance to their credit in one taxable year.

#### HOLDING (ISSUE 2)

The distributions to A, B and C will be considered lump sum distributions within the meaning of section 402(e)(4)(A) of the Code and, thus, are entitled to special tax treatment even though amounts subject to the restrictions of section 1.401-4(c) or 1.401(a)(4)-5(b) of the regulations may have to be repaid to the plan.

#### EFFECT ON OTHER REVENUE RULINGS

Rev. Rul. 81-135 is obsolete because the position stated therein is restated under current law in this revenue ruling.