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Disposing of a Pre-Existing H.R. 10 Plan in Connection with a Post-ERISA Business Incorporation

J. Clifton Fleming, Jr.*

I. INTRODUCTION

A striking legal trend of the years immediately preceding the enactment of the Employee Retirement Income Security Act of 1974 (ERISA)1 was the rush to obtain corporate retirement plan benefits for proprietor-employees by incorporating their partnerships and proprietorships. Although the wisdom of such action was never quite so compelling as suggested by its advocates2 and has been rendered less compelling by ERISA improvements to plans created under the Self-Employed Individuals Tax Retirement Act (H.R. 10),3 the popularity of transforming proprietorships and partnerships, particularly medical practices, into corporations will probably continue. Since these unincorporated businesses will frequently have pre-existing H.R. 10 plans, proper disposition of such plans in light of the new law will be a recurring problem for tax advisers.

The principal alternatives for disposing of an H.R. 10 plan upon incorporation are to freeze the plan, merge the plan into the successor corporation’s plan, or make a liquidating distribution of plan assets to the participants. This article will examine each of the foregoing options as if all ERISA provisions were presently effective; there will be no consideration of ERISA’s intricate system of effective dates.4 For the sake of convenience, all references herein to a “plan” or “retirement plan” include both the plan and its accompanying funding medium, such as a trust, annuity contract, or custodial account.

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4. As this article was being written, new administrative rulings, releases, and regulations on major ERISA topics were appearing almost daily. Both the author’s mental health and law review publication schedules required the article to be prepared without reflecting events occurring after a given date. Therefore, with few exceptions, developments after November 15, 1975, are not considered.
II. Disposing of the H.R. 10 Plan

A. Freezing the Plan

Freezing an H.R. 10 plan is the cleanest way to dispose of it. Contributions cease, no new participants are added, no further benefits accrue, participants draw their benefits as they become eligible under the plan’s terms, and the plan’s assets are not mingled with the assets of the new corporation’s retirement plan. However, a freeze raises the following problems and questions.

1. Takeover by the Successor Corporation—To continue in a qualified or tax exempt status, a plan must be maintained by an employer.\(^5\) Hence, when the assets, activities, and employees of the unincorporated business are transferred to a newly formed corporation and the employer that established the H.R. 10 plan thereby disappears, the plan must be taken over by a new employer to avoid disqualification. The frozen H.R. 10 plan should be formally adopted by the new corporation to provide a sponsoring employer\(^6\) and to preserve its qualified status even though the new corporation will make no contributions.\(^7\)

2. Qualified Status of the Plan Trust Following a Freeze—If the new corporation adopts the frozen plan, any trust or custodial account used to fund the plan\(^8\) will continue in tax exempt status following the freeze,\(^9\) subject to two caveats.

   (a) Limitations on Benefits to Highly Compensated Employees—The Internal Revenue Service has long maintained that if benefits under a defined benefit pension plan\(^10\) become payable to highly compensated employees prior to funding of full current costs for the plan’s first ten years or that if a defined benefit plan is terminated before it has completed ten years of existence, plan benefits made available to highly compensated employees must be limited to amounts permitted

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6. There is nothing to prevent a corporation from adopting a plan with H.R. 10 limitations.

7. Note that if the frozen H.R. 10 plan was funded with a custodial account, section 403 of ERISA may require the successor corporation adopting the frozen plan to appoint a trustee who will control investment of the custodial account assets. See H.R. Conf. Rep. No. 93-1280, 93d Cong., 2d Sess. 299 (1974).

8. \(8.\) Id.


10. Note that section 401(j) of the Internal Revenue Code now authorizes defined benefit plans for self-employed persons. Prior to ERISA, it was theoretically possible to create a defined benefit H.R. 10 pension plan, but such plans were impractical and rare. See S. Rep. No. 93-383, 93d Cong., 1st Sess. 1,122-23 (1973); H.R. Rep. No. 93-807, 93d Cong., 2d Sess. 1,113-14 (1974).
by rules presently contained in section 1.401-4(c) of the Treasury Regulations. These rules remain applicable to frozen plans under ERISA.

(b) Withdrawal Option—Frozen plans are sometimes amended to allow employees the option of withdrawing their retirement benefits during a limited period or leaving them in the plan to be paid out at death, retirement, or disability. This election may result in elimination of some plan participants, and with the passage of time, additional participants will be terminated through retirement, death, or other reasons. If participant losses from one or both of these causes result in the frozen plan covering a disproportionately high number of officers, shareholders, or highly compensated employees of the new corporation, the Internal Revenue Service will insist that the plan has lost its qualified status on discrimination grounds, with the result that the trust becomes taxable. Accordingly, before amending the H.R. 10 plan to provide a withdrawal option, careful assessment should be made as to whether lower paid employees are likely to withdraw their interests in numbers sufficient to cause a discrimination problem.

3. Full Vesting of Benefits—Most H.R. 10 plans cover at least one owner-employee with the result that the interests of all participants are one hundred percent vested from commencement of participation. If an H.R. 10 plan covers no owner-employees, however, participants' interests may be less than fully vested when the freeze occurs. If the interests in a qualified plan were less than one hundred percent vested at the time of the freeze, pre-ERISA law required that full vesting occur simultaneously with the freeze, to the extent benefits were accrued and funded under a defined benefit plan and to the extent of the partici-
pants' account balances under an individual account plan. In the case of plan freezes, ERISA perpetuates this requirement only for plans exempt from the funding rules of the Internal Revenue Code. Since H.R. 10 money purchase and defined benefit pension plans are covered by these funding rules, neither will be required to provide complete vesting at the time of a freeze. Full vesting will be required, however, in the case of an H.R. 10 profit-sharing plan freeze.

4. Minimum Funding Rules—Although the minimum funding rules of sections 301 through 306 of ERISA and section 412 of the Internal Revenue Code, as well as the excise taxes on underfunding imposed by section 4971 of the Code, are inapplicable to H.R. 10 profit sharing plans, they do apply to H.R. 10 pension plans. Thus, it is possible for a frozen H.R. 10 plan to have an accumulated funding deficiency when taken over by a successor corporate employer. In such a case, section 4971 of the Code would apparently make the successor corporation liable for the penalty taxes on underfunding as to post-incorporation years during which the funding deficiency was allowed to remain unsatisfied, but not as to pre-incorporation years. Furthermore, section 502 of ERISA would apparently permit an interested party or the Secretary of Labor to compel the successor corporation by civil injunction to satisfy any inherited funding deficiency in a frozen H.R. 10 pension plan. However, the economic burden of the successor corporation's correction of the underfunding will, in effect, be borne by the corporation's shareholders, and those individuals will usually be the self-employed persons who would have borne that burden anyway had the business remained unincorporated and had the H.R. 10 plan continued. This carryover liability for underfunding, therefore, should not have any significant impact on a decision to incorporate a business and freeze its H.R. 10 plan.


20. INT. REV. CODE OF 1954, §§ 412(a), (h)(1); ERISA § 301(a)(8).

21. Under ERISA sections 203(b) and 210(b), accrued benefits would, of course, continue to vest in accordance with the plan's vesting schedule. Also, as indicated by ERISA section 204(g), the freeze amendment ordinarily could not reduce accrued benefits.

22. INT. REV. CODE OF 1954, §§ 412(h)(1), 4971(a); ERISA §§ 301(a)(8), (3)(34).

23. However, note that the Labor Department considers an H.R. 10 plan entirely exempt from ERISA funding rules where the plan covers no common law employees. 26 C.F.R. § 2510.3-3(b) (1975), in 2 CCH PENSION PLAN GUIDE ¶ 14,133. The funding requirement for a money purchase pension plan is generally annual payment of "the amount that must be contributed for the year under the plan formula." H.R. CONF. REP. No. 93-1280, supra note 7, at 284.

24. See INT. REV. CODE OF 1954, §§ 4971(a), (b); H.R. REP. No. 93-807, supra note 10, at 1,297-98.
5. **ERISA Termination and Insurance Provisions**

(a) *Notice*-Section 4041(a) of ERISA provides that before a plan termination effective date, the plan administrator must notify the Pension Benefit Guaranty Corporation (PBGC) of the proposed termination and, generally speaking, the administrator cannot thereafter make plan distributions until PBGC clearance of the termination is obtained. However, the PBGC interprets this section as exempting from the notice and clearance requirements all individual account plans, all defined benefit plans which cover only sole proprietors or partners owning more than a ten percent interest in the partnership capital or profits, and all defined benefit plans established and maintained by a professional service employer which does not at any time after the date of enactment of this Act have more than 25 active participants in the plan.\(^{25}\)

Consequently, most H.R. 10 plan freezes will be relieved from the section 4041 requirements by the foregoing exemptions.

A few cases involving defined benefit plan freezes, however, will not be covered by these exemptions. In such cases, compliance with the section 4041(a) termination notice and clearance procedures will be required if a “freeze” is a “termination” for purposes of the section. The legislative history of the ERISA termination insurance provisions, which include section 4041, states that

> [a] plan termination in the sense that benefits stop accruing . . . is not to be termination under the insurance provisions so long as the employer continues to meet the funding standards . . . .\(^{26}\)

This statement implies that if a defined benefit plan not covered by one of the above exemptions (or some other exemption under section 4021 (b)) has a funding deficiency when frozen, or has unamortized liabilities extending over future years,\(^{27}\) the freeze will constitute a termination requiring compliance with the section 4041(a) notice and clearance procedures. However, it should be possible to freeze a defined benefit plan without complying with section 4041(a) if the plan has neither a funding deficiency nor unamortized liabilities.

(b) *Termination Liability*-Section 4062(b) of ERISA provides that whenever a covered employer terminates a plan, the employer shall be liable to the PBGC

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25. PBGC News Release 76-2 §§ 4021(a)-(F, 4041(a)-(A, 4043(b)-(8)-B(July 22, 1975), in P-H Pen. & Profit Shri. Serv. ¶ 120,030; ERISA §§ 4021(b)(1), (9), (13). The list of exemptions given in the text is not exhaustive; it merely identifies those most commonly applicable to H.R. 10 plans.


in an amount equal to the lesser of—

(1) the excess of—

(A) the current value of the plan’s benefits guaranteed under this title on the date of termination over

(B) the current value of the plan’s assets allocable to such benefits on the date of termination, or

(2) 30 percent of the net worth of the employer determined as of a day, chosen by the corporation but not more than 120 days prior to the date of termination, computed without regard to any liability under this section.

Again, however, individual account plans, defined benefit plans covering only sole proprietors or partners holding more than a ten percent interest in the business, and defined benefit plans of professional service employers having no more than twenty-five active plan participants, are exempt from section 4062(b) liability. Furthermore, in the few cases where section 4062(b) attaches to an H.R. 10 plan freeze, the self-employed individuals bearing section 4062(b) liability will be those who would have, in effect, assumed the liability through contributions to the plan had the business remained unincorporated. Therefore, section 4062(b) should have no substantial impact on a decision to incorporate a proprietorship or partnership and freeze the H.R. 10 plan.

(c) Allocation Priorities—Section 4044 of ERISA establishes a mandatory scheme of priorities for allocating assets on termination of a defined benefit plan covered by the ERISA termination insurance provisions. By virtue of section 403(d)(1) of ERISA, these allocation priorities also apply to the termination of all other plans funded at least in part with employer contributions, except to the extent the Secretary of Labor otherwise provides by regulation. It seems clear, then, that section 4044 priorities will apply to all H.R. 10 plan freezes which are considered “terminations” within the meaning of sections 4044 and 403(d)(1).

Since a freeze constitutes a termination for purposes of the ERISA insurance provisions (which include section 4044) only where the plan has a funding deficiency or unamortized liabilities when frozen, the freeze of an H.R. 10 plan that does not fall within either of these categories is not a termination and will not be subject to section 4044 priorities. Since section 403(d)(1) incorporates the termination allocation priorities of section 4044, it also seems likely that “termination” has the same

30. H.R. Conf. Rep. No. 93-1289, supra note 7, at 303-04. There are no final or proposed regulations exempting otherwise covered plans from section 4044.
31. See text accompanying notes 26-27 supra.
meaning in that section as well. Therefore, section 403(d)(1) will not impose the section 4044 priorities on frozen plans which are free of funding deficiencies and unamortized liabilities.

Since profit-sharing plans have no funding deficiencies or amortizable liabilities, these freezes of these plans will not be required to conform to section 4044 allocation priorities. As to money purchase pension plans with such deficiencies or liabilities, the allocation priorities do no more than confirm the rights of participants to receive their account balances.

6. Permanency—In the pre-ERISA period, the Internal Revenue Service asserted that a plan had to be intended as a permanent program from the beginning in order to be qualified:

The term “plan” implies a permanent as distinguished from a temporary program. Thus, although the employer may reserve the right to change or terminate the plan, and to discontinue contributions thereunder, the abandonment of the plan for any reason other than business necessity within a few years after it has taken effect will be evidence that the plan from its inception was not a bona fide program for the exclusive benefit of employees in general. Especially will this be true if, for example, a pension plan is abandoned soon after pensions have been fully funded for persons in favor of whom discrimination is prohibited under section 401(a). The permanency of the plan will be indicated by all of the surrounding facts and circumstances, including the likelihood of the employer’s ability to continue contributions as provided under the plan.

Failure to satisfy this permanency requirement resulted in the plan’s retroactive disqualification, and there is no indication that ERISA has abolished or modified the requirement.

In Revenue Ruling 69-25, the Commissioner of Internal Revenue ruled that the permanency requirement would be violated if within a few years after creation, a plan was terminated in connection with a transfer of the sponsoring employer’s assets to a new corporation and the transfer had been contemplated at the time the plan was established:

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32. Int. Rev. Code of 1954, § 412(b)(1); ERISA § 301(a)(8).
33. See ERISA §§ 304(b)(2)(B), (c)(2)(A), 3(29)(B), 4044(a).
34. However, early abandonment of a plan can cause retroactive disqualification for failure to meet the permanency requirement even though the abandonment produces no prohibited discrimination. Rev. Rul. 69-25, § 4.01, 1969-1 Cum. Bull. 113, 114.
37. In Rev. Rul. 69-24, 1969-1 Cum. Bull. 110, 112 (Situation 3), the Commissioner ruled by implication that five or fewer years would be treated as “a few years” for purposes of the permanency requirement. However, in Rev. Rul. 72-239, 1972-1 Cum. Bull. 107, the Commissioner ruled that a plan which had existed long enough for the restrictions under Treas. Reg. 1.401-4(c)(1960) to expire (usually a ten year period) had been maintained for more than a “few years.”
When a newly established plan is first considered for a determination letter . . . the presumption is that the plan is being established in good faith as a permanent program . . .

. . . [W]hen a plan is discontinued within a few years after its adoption for any cause other than business necessity, the original presumption of intended permanence must be replaced by a presumption that the employer did not intend the plan as a permanent program from the beginning. In the absence of evidence rebutting this presumption, such a plan would then be disqualified retroactively as not being a permanent plan for the exclusive benefit of the employees in general.

. . . .

The presumption as to lack of a bona fide permanent program in the case of a plan that is terminated within a few years may be overcome in certain situations in which the business is sold or transferred to a successor, and the successor immediately terminates the plan, even though such termination may not be due strictly to business necessity . . . .

. . . [This] exception . . . would not apply, however, where a subsequent sale or transfer of the business and the consequent termination of the plan might have been anticipated at the time the plan was adopted. Nor would the exception apply in the case where the successor to the business was closely associated with the previous ownership or management.38

The Commissioner's statement suggests that if the owner or owners of an unincorporated business adopt an H.R. 10 plan with the intention of incorporating the business and freezing or otherwise abandoning the plan within a few years, the H.R. 10 plan will be retroactively disqualified under the permanency rule.39 Therefore, persons contemplating incorporation should resist the temptation to generate retirement savings deductions for the period leading up to incorporation by adopting an H.R. 10 plan that will be frozen or otherwise abandoned upon incorporation.40

7. Compliance with Participation Standards—Section 202 of ERISA and section 410 of the Internal Revenue Code impose a requirement which, generally speaking, prohibits exclusion from plan participation because of age or length of service where the employee is at least twenty-five years old and has at least one year of service. When a successor corporation takes over a frozen H.R. 10 plan,41 thus making it the corporation's plan, the corporation may at that time or in the future have employees who meet the new statutory length of service and age standards, but who were never previously covered by the H.R. 10 plan.

41. See text accompanying notes 5-7 supra, for an explanation of why the successor corporation should take over the H.R. 10 plan of its unincorporated predecessor.
ERISA section 202 and Internal Revenue Code section 410 do not require the corporation to permit these employees to share in the benefits of the frozen H.R. 10 plan. Requirements other than age and length of service can be used to exclude employees from a plan, even where those employees meet the statutory age and length of service standards. Thus, employees of the successor corporation meeting the foregoing standards could nevertheless be excluded from the frozen H.R. 10 plan on the ground that they had not been covered by the plan during the time it was maintained by the unincorporated predecessor business.

8. Sale of Assets—A frozen H.R. 10 plan may contain assets such as insurance policies or mortgaged property which require periodic cash payments in excess of plan earnings. Since a frozen plan has no incoming cash contributions, some method must be found to maintain current payments on these assets to prevent their termination or loss.

In Revenue Ruling 73-503, the Commissioner of Internal Revenue stated that the trust funding a corporate plan could purchase assets at fair market value from the trust funding an H.R. 10 plan without disqualifying the corporate trust and without the necessity of amending the corporate plan to include section 401(d) distribution and trustee requirements. Through use of this device, assets requiring periodic payments could be shifted to the corporate plan which had the employer's cash contributions available.

Unfortunately the solution provided by Revenue Ruling 73-503 will, in many cases, be unavailable for post-ERISA incorporations. Section 406 of ERISA and section 4975 of the Internal Revenue Code prohibit certain transactions, including the “sale or exchange, or leasing, of any

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42. H.R. CONF. REP. No. 93-1280, supra note 7, at 262-83.
43. This conclusion is supported by the following excerpt from Technical Information Release 1334:
   Q. Must a qualified plan to which IRC Section 410 . . . applies cover all of a company's employees who satisfy the minimum age and service requirements of IRC Section 410 (a)(1)?
   A. No. IRC Section 410(a)(1) does not require that an employee be eligible for plan participation merely because he satisfies the specified age and service requirements. Other requirements, not related to age or service, may be imposed by a plan as a condition of participation. For example, a plan which requires that an employee complete 1 year of service and attain age 25, as a condition of participation, may exclude employees who are paid on an hourly basis. The exclusion of hourly paid employees does not cause the plan to be disqualified merely because it results in the exclusion of some employees who satisfy the minimum age and service requirements. . . .
   P-H PEN. & PROFIT SHAR. SERV. ¶ 107,026 (Jan. 8, 1975). However, see the discussion of discriminatory coverage in text accompanying notes 12-15 supra.
44. 1973-2 CUM. BULL. 142.
45. INT. REV. CODE OF 1954, § 401(d).
46. Presumably, once the purchase of assets occurred, the H.R. 10 plan would remain qualified, although the ruling is silent on this issue.
property between the plan and a party in interest." 47 Therefore, if the retirement plan trust of a successor corporation were a "party in interest" with respect to an unincorporated predecessor's H.R. 10 plan, a sale of assets by the H.R. 10 plan to the corporate plan would be prohibited. 48

Section 3(14) of ERISA indicates that a successor corporation's retirement plan trust will be a party in interest with respect to a non-corporate predecessor's H.R. 10 plan if fifty percent or more of the beneficial interest of the corporate trust is owned by a person or persons who are fiduciaries of the H.R. 10 plan ("fiduciary" being defined broadly enough arguably to include the shareholder-managers of the new corporation) 49 and/or fifty percent stock owners of the new corporation. 50 Section 4975 of the Internal Revenue Code contains parallel provisions. Therefore, in many cases sales of assets from an H.R. 10 plan to a corporate successor's plan 51 will be prohibited, and a merger of the H.R. 10 plan into the corporate plan may be the only method for providing cash to carry H.R. 10 assets which require periodic payments. 52 As


48. Note, however, that the Labor Department considers an H.R. 10 plan exempt from the ERISA prohibited transactions rules where the plan covers no common law employees. 29 C.F.R. § 2510.3-3(b) (1975), in 2 CCH PENSION PLAN GUIDE ¶ 14,133. There is no corresponding exemption from the prohibited transactions rules under the Internal Revenue Code. It is difficult to believe that Congress intended the result suggested in the text, yet the statute appears to require that result. It would seem appropriate for the Secretaries of Labor and the Treasury to use their respective powers under section 408(a) of ERISA and section 4975 (c)(2) of the Internal Revenue Code to exempt transactions described in Rev. Rul. 73-503 from the prohibited transactions rules.

49. Legislative history behind the passage of ERISA describes the scope of the term "fiduciary" as follows:

The substitute defines "fiduciary" as any person who exercises any discretionary authority or control respecting management of a plan, exercises any authority or control respecting the management or disposition of its assets or has any discretionary authority or responsibility in the administration of the plan. Under this definition, fiduciaries include officers and directors of a plan, members of a plan's investment committee and persons who select these individuals. Consequently the definition includes persons who have authority and responsibility with respect to the matter in question, regardless of their formal title.

H.R. CONF. REP. No. 93-1280, supra note 7, at 323 (emphasis added).

50. In relation to an employee benefit plan, "party in interest" means:
(A) any fiduciary . . . of such employee benefit plan; . . .
(C) an employer any of whose employees are covered by such plan; . . .
(E) an owner, direct or indirect, of 50 percent or more of—
   (i) the combined voting power of all classes of stock entitled to vote or the total value of shares of all classes of stock of a corporation . . . which is an employer . . . described in subparagraph (C) . . .
   (G) a . . . trust . . . of which (or in which) 50 percent or more of—
   (iii) the beneficial interest of such trust . . . is owned directly or indirectly, or held by persons described in subparagraph (A) . . . or (E) . . .

ERISA § 3(14).

51. The sale may also be a prohibited transaction as to the corporate plan.

52. See Rev. Rul. 71-541, 1971-2 CUM. BULL. 209. However, note ERISA § 408(a) and Int. Rev. Code of 1954, § 4975(c)(2), which provide for the granting of ad hoc exemptions.
will be seen subsequently, however, such a merger may itself be a prohibited transaction.\footnote{33}

\section*{B. Merging an H.R. 10 Plan with a Corporate Plan}

In Revenue Ruling 71-541, the Commissioner of Internal Revenue ruled that where a partnership was dissolved and its assets transferred to a new corporation, the partnership’s H.R. 10 profit-sharing plan could be merged into the new corporation’s profit-sharing plan, without disqualifying the corporate plan, by means of a direct transfer of assets from the H.R. 10 plan trust to the corporate plan trust.\footnote{34} Also, if the H.R. 10 assets were transferred directly to the corporate plan trust, the merger would result in neither a premature distribution to the owner-employees nor an actual or constructive receipt by the other participants.\footnote{35} However, where an H.R. 10 plan covers owner-employees, the corporate plan would have to provide that assets received from the H.R. 10 plan on behalf of owner-employees remain subject to the trusteeship and time of distribution requirements of section 401(d) of the Internal Revenue Code.\footnote{36}

\subsection*{1. Comparison Between “Merger” and “Freeze”—Although Reve-}

\footnote{33. See text accompanying notes 60-64 infra.}
\footnote{34. 1971-2 CUM. BULL. 209. See also Letter Ruling (Feb. 18, 1971), in P-H PEN. & PROFIT SHAR. SERV. ¶ 67.189. Presumably, the merger would have no impact on the prior qualified status of the H.R. 10 plan, although the ruling did not address this question. See Rev. Rul. 58-406, 1958-2 CUM. BULL. 153. However, the caveat concerning the permanency requirement, text accompanying notes 35-40 supra, is applicable to a plan merger.}
\footnote{35. In Rev. Rul. 73-259, 1973-1 CUM. BULL. 199, the Commissioner stated that an H.R. 10 plan funded with individual annuity contracts held by the participants could be merged into the trusteed plan of a successor corporation by the participants surrendering their contracts to the insurer who then issued new contracts to the trustee under the corporate plan. However, the Service contended that merger of such plans could not be effected by the H.R. 10 plan participants making a direct transfer of their individual contracts to the corporate plan. Answers by Isidore Goodman to questions following address to the Association for Advanced Life Underwriting, Washington, D.C., Feb. 14, 1972, in P-H PEN. & PROFIT SHAR. SERV. ¶ 71.515, at 71, 598. This latter position may have been rendered obsolete by the ERISA amendment to INT. REV. CODE OF 1954, § 401(f).}
\footnote{36. To avoid premature distributions and actual or constructive receipt in connection with a merger of plans, the safest course is to provide for a direct transfer between the funding media of the plans involved. See Rev. Rul. 69-254, 1969-1 CUM. BULL. 129. For limited cases in which H.R. 10 plan assets can pass through the participants’ hands in a merger situation without adverse tax consequences to the participants, see Keith L. Doing, 58 T.C. 115 (1972), acquiesced in, 1972-2 CUM. BULL. 2; Rev. Rul. 55-368, 1955-1 CUM. BULL. 40.}
\footnote{54. Letter Ruling, supra note 54; Answer by Isidore Goodman to question following address at the 1971 Kansas Tax Conference, Wichita, Kansas, Nov. 12, 1971, in P-H PEN. & PROFIT SHAR. SERV. ¶ 71.514, at 71, 590; Rev. Rul. 73-259, 1973-1 CUM. BULL. 199.}
nue Ruling 71-541 approved the merger of H.R. 10 and corporate plans, the ruling's requirement that H.R. 10 assets attributable to owner-employees remain subject to the H.R. 10 time of distribution requirements means, as a practical matter, that those assets must be accounted for separately from other funds of the corporate trust to ensure that H.R. 10 requirements are not violated. Thus, whenever an H.R. 10 plan covers owner-employees, its merger into the plan of a successor corporation would produce approximately the same result as if the H.R. 10 plan had been frozen rather than merged. Isidore Goodman, former Chief of the Pension Trust Branch of the Internal Revenue Service, has described the situation in the following terms:

The effect [of a merger of an H.R. 10 plan covering owner-employees into a corporate plan] is the same as though two plans were maintained, one for the funds benefitting the former owner-employees (which continue subject to the HR 10 restrictions) and the other for new funds. As a practical matter, the former HR 10 plan is "frozen" and remains subject to the HR 10 rules until the funds are distributed, and a new plan is adopted by the corporation without HR 10 restrictions.

However, while a freeze of an H.R. 10 plan avoids any premature distribution problems, a mishandled merger could expose owner-employees to such dangers. Therefore, despite the similarity in ultimate result between a merger and a freeze, the wisdom of merging an H.R. 10 plan covering owner-employees into a corporate plan is questionable. In addition, other questions concerning the propriety of a merger might be raised.

2. Prohibited Transactions Rules—In addition to the proscription against the sale of plan assets, section 406 of ERISA and section 4975 of the Internal Revenue Code prohibit "a transfer to . . . a party in interest, of any assets of the plan. . . ." This prohibition covers transfers to a successor corporation's retirement plan trust that is "a party in interest" with respect to an unincorporated predecessor's H.R. 10 plan. In many cases, persons who are fiduciaries of the H.R. 10 plan and/or fifty percent stock owners of the new corporation which now employs the H.R. 10 plan participants will own fifty percent or more of the successor corporation's retirement plan trust, thereby making that corporation's plan trust a "party in interest" with respect to the predecessor's H.R. 10 plan and prohibiting a merger of the H.R. 10 plan into the corporate trust.
The successor corporation’s plan trust may not always be considered a party in interest, however. If the corporate trust has no assets at the time of the merger, then perhaps no one has any beneficial interest in the trust, with the result that it cannot be considered a party in interest as to the H.R. 10 plan under the foregoing rules. Whether such an interpretation will prevail cannot be ascertained until regulations are promulgated. In the interim, it may be possible to avoid having a merger of an H.R. 10 and corporate plan treated as a prohibited transaction under the foregoing rules if the successor corporate plan is a non-trusteep annuity plan. To effect such a merger, H.R. 10 trust assets could be transferred to an insurer to be held under an annuity contract acquired by the successor corporation. Since this transfer would not be to a trust predominantly owned by parties in interest of the H.R. 10 plan as defined in section 3(14) of ERISA, it would not be prohibited under section 406(a)(1)(D).

3. Merger of an H.R. 10 Profit-Sharing Plan Into a Corporate Pension Plan—Treasury regulations have long provided that a qualified retirement plan must be “established by an employer for the exclusive benefit of his employees or their beneficiaries.” As part of this requirement, the regulations provide that a profit-sharing plan does not meet this “exclusive benefit” test if funds contributed to the profit-sharing plan can be used to reduce the employer’s cost of concurrently maintaining a pension plan. The Commissioner of Internal Revenue, in explaining the rationale underlying this rule, has stated:

plan on the theory that the corporate plan participants who were owners of the predecessor business are covered by sections 3(14)(C), (E)(ii), and (iii) of ERISA, and sections 4975(e)(2)(C), (E)(ii), and (iii) of the Internal Revenue Code.

The term “fiduciary” is defined broadly enough by ERISA arguably to include the shareholder-managers of the new corporation. See note 49 supra.

64. Since it is difficult to believe that Congress intended that plan mergers meeting the requirements of Rev. Rul. 71-541 and section 208 of ERISA should suffer the result suggested in the text, it would seem appropriate for the Secretaries of Labor and the Treasury to exempt such mergers from the prohibited transactions rules by exercise of their respective powers under section 408(a) of ERISA and section 4975(c)(2) of the Internal Revenue Code.

65. See ERISA § 403(b)(1).

66. See note 50 supra.

67. See note 49 supra. An annuity contract is treated as a trust only under section 401 of the Internal Revenue Code. See § 401(f). However, if the H.R. 10 plan is funded with an insurance or annuity contract providing benefits based on investment performance and the plan of the successor corporation is funded by a contract with the same insurer, a merger of the two plans might be treated as a transfer of the H.R. 10 assets to a fiduciary of the H.R. 10 plan—a transaction prohibited by section 406(a)(1)(D) of ERISA. See ERISA §§ 3(14)(A), 3(21)(A); H.R. CONF. REP. No. 93-1280, supra note 7, at 296. It is difficult to believe that Congress intended such a consequence; perhaps the result will be foreclosed by regulation.


69. Id. § 1.401-1(b)(3).
A stock bonus or profit-sharing plan that provides that the funds therein may be used to meet the costs of a pension or annuity plan operated concurrently and covering the same employees, if and when the employer suspends contributions to the latter plan, is generally called a "feeder" plan. Such a plan does not qualify because it relieves the employer from contributing to the pension or annuity plan and, therefore, is not for the exclusive benefit of employees or their beneficiaries. . . .

Although it was once suggested that this prohibition against feeder plans would bar the merger of a profit-sharing plan into a defined benefit pension plan, more recent developments indicate that such a merger should encounter no difficulty on this point. In Revenue Ruling 70-578, for example, the Internal Revenue Service stated that the feeder plan prohibition is not violated where an employer establishes a profit-sharing plan, and then several years later, establishes a pension plan which provides each profit-sharing participant with a defined retirement benefit reduced by an amount of benefit actuarially equivalent to his profit-sharing trust balance at the time of the pension plan's establishment. The considerations behind this ruling were stated as follows:

Although the two plans in this case are maintained concurrently for the same employees, contributions made under the profit-sharing plan during the period that both plans are maintained and trust earnings credited during that period will not reduce, or otherwise affect, the em-

70. IRS Pub. 778, ¶ 2Q in 3 CCH PENSION PLAN GUIDE ¶ 17,003, at 20,224.
72. As indicated by the textual quotation at note 69 supra, the rationale for the rule prohibiting use of profit-sharing funds to reduce employer pension costs is that the profit-sharing funds are being used to pay an employer obligation and, therefore, the profit-sharing plan is not for the exclusive benefit of employees and their beneficiaries. In most cases, an employer does not bind himself to make contributions to a profit-sharing plan but reserves the right to contribute or not contribute as he sees fit. But see Treas. Reg. § 1.401-1(b)(2)(1960). Therefore, unlike a pension plan, a profit-sharing plan does not involve a funding obligation on the employer's part and the feeder plan prohibition does not prevent pension plan assets from being used to fund profit-sharing plan benefits. Compare Rev. Rul. 69-502, 1969-2 CUM. BULL. 89 with Rev. Rul. 70-371, 1970-2 CUM. BULL. 85. Accordingly, a merger of a pension plan into a profit-sharing plan would not violate the feeder plan prohibition, although the practical problems of such a merger make its wisdom doubtful in cases involving defined benefit pension plans. See Lurie, Pensions After Mergers and Spin-Offs, 10 Tax L. Rev. 531, 541 (1955). Nor should there be any problem on this point with a merger of a profit-sharing plan into a money-purchase pension plan. A money-purchase plan requires that an employer make defined annual contributions regardless of the amount of assets in the plan. Thus, the employer's contribution obligation would be unaffected by a transfer of profit-sharing funds to a money-purchase pension plan.
73. 1970-2 CUM. BULL. 85.
74. Presumably, it is not necessary for earnings on the profit-sharing account balances as of establishment of the pension plan to be dealt with in this fashion. The issue is whether the profit-sharing plan is being used to fund the obligation undertaken by the employer with respect to the pension plan. If the employer's pension obligation is to fund
ployer's liability to make contributions under the pension plan. The profit-sharing funds do not relieve the employer from making contributions to the pension plan because, from the inception of the pension plan, there was no possibility that the employer might have to make contributions to the pension plan with respect to the reduction . . . .

The language of Revenue Ruling 70-578 suggests that a profit-sharing plan which reduces pension plan benefits is not to be treated as relieving an employer of his pension obligations in violation of the feeder plan rule where the amount of the reduction is fixed in terms of profit-sharing account balances existing at the time the profit-sharing participants obtained coverage under the pension plan. In such a situation, the employer's pension obligation to the profit-sharing participants does not exceed the reduced pension benefit, and the profit-sharing funds are not relieving the employer of any obligation. Thus, the H.R. 10 profit-sharing plan of a predecessor unincorporated business could be merged into the successor corporation's pension plan, since the amount of pension benefit to be funded by the profit-sharing assets would be fixed at the time the profit-sharing participants came into the pension plan and would never be part of the successor corporation's pension plan obligations.

4. **Full Vesting of Benefits**—If an H.R. 10 profit-sharing plan is merged into a corporate pension plan, or if an H.R. 10 pension plan is merged into a corporate profit-sharing or stock bonus plan, the H.R. 10 plan is considered terminated for tax purposes. An H.R. 10 pension plan, however, is not deemed terminated by merger into a corporate pension plan, nor is an H.R. 10 profit-sharing plan deemed terminated by merger into a corporate profit-sharing or stock bonus plan. Where a merger results in the termination of an H.R. 10 plan, both the old law and ERISA require that all unvested interests in the plan become one hundred percent vested.

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5. Limitations on Benefits to Highly Compensated Employees—Where a merger of an H.R. 10 defined benefit plan into a corporate plan constitutes termination of the H.R. 10 plan for tax purposes under the foregoing rules, the limitations on benefits to highly compensated employees under Treasury Regulation 1.401-4(c) will be applicable unless it can be established that discrimination will not otherwise likely result. The effect of these limitations will probably be to circumscribe the amount of benefit funded under the corporate plan for highly compensated employees with H.R. 10 assets.

6. Minimum Funding Rules—When an H.R. 10 plan disappears by merger into the plan of a corporate successor, any funding deficiency of the H.R. 10 plan will probably be extinguished as to periods following the merger unless the merger terms require the corporate plan to assume payment of underfunded benefits provided by the H.R. 10 plan. In such an event, the successor corporation will inherit the H.R. 10 plan’s funding deficiency and will be liable for the section 4971 penalty taxes on underfunding as to post-incorporation years during which the deficiency is allowed to continue, but not as to pre-incorporation periods. The owners of a previously unincorporated business that maintained the H.R. 10 plan will apparently remain liable for the section 4971 underfunding taxes with respect to periods preceding the merger.

7. ERISA Benefit Preservation Requirements—Section 208 of ERISA and supporting Internal Revenue Code provisions require that the post merger retirement benefits of a participant in the non-surviving plan be at least as great as his pre-merger benefits. Since the benefits under corporate plans are usually more generous than under H.R. 10 plans, however, section 208 should not play a significant role in mergers of H.R. 10 plans into corporate plans.

8. ERISA Termination and Insurance Provisions—As noted previously, section 4041 of ERISA requires notice to the PBGC and PBGC clearance of plan terminations, and section 4062(b) imposes liability on employers terminating underfunded plans. Also, sections 403(d)(1) and 4044 of ERISA prescribe a rigid priority system for allocating the assets of a terminated plan. Although each of the foregoing requirements is subject to significant exceptions in the case of H.R. 10 plans, some H.R. 10 plans are covered. Therefore, with respect to the merger of an H.R. 10 plan into a corporate plan which results in the H.R. 10 plan’s termi-
nation for tax purposes the question arises as to whether the merger will also be treated as a “termination” of the H.R. 10 plan for purposes of the above ERISA provisions. In addition, where an H.R. 10 pension plan is merged into a corporate pension plan or an H.R. 10 profit-sharing plan is merged into a corporate profit-sharing plan or stock bonus plan, the question arises as to whether the H.R. 10 plan will be considered “terminated” for purposes of the foregoing ERISA provisions even though it would not be terminated for tax purposes. 87

Section 4043(b)(4) of ERISA provides that the “occurrence of . . . a termination or partial termination [within the meaning of section 411(d)(3) of the Internal Revenue Code] does not, by itself constitute or require a termination of a plan under this title.” 88 Thus, it appears that regardless of whether the merger of one plan into another is treated as a termination of the non-surviving plan for tax purposes, the merger must be examined in light of the terms and legislative history of ERISA to determine whether it constitutes a “termination” thereunder.

Although ERISA fails to define “termination,” legislative history indicates that the term, as well as the provisions applicable to plan terminations, are limited to freezes of underfunded plans 89 and to plan liquidations. 90 As discussed above, 91 section 208 of ERISA seems to be the exclusive provision for protecting employee benefits in a plan merger. In addition, section 4043(b) states that a plan merger under section 208 invokes a procedure for notice to the PBGC that is more limited than the notice procedure applicable to plan terminations under section 4041. If a plan merger were a “termination” for purposes of section 4041, there would be no need for section 4043(b) to require notice to the PBGC, since that matter would have been dealt with by section 4041. Therefore, the separate notice requirement for plan mergers contained in section 4043(b) strongly implies that such transactions are not “terminations” for purposes of section 4041. Also since sections 4062(b), 403(d)(1), and 4044 are part of the same statutory scheme as section 4041 and presumably use terms with uniform meanings, the foregoing analysis leads to the conclusion that plan mergers are not terminations

87. Note 76 supra.
88. Int. Rev. Code of 1954, § 411(d)(3) provides:
[A] trust shall not constitute a qualified trust under section 401(a) unless the plan of which such trust is a part provides that— . . . .

[B] . . . upon complete discontinuance of contributions under the plan, the rights of all affected employees to benefits accrued to the date of such termination, partial termination, or discontinuance, to the extent funded as of such date, or the amounts credited to the employees’ accounts, are nonforfeitable.
89. See also H.R. Conf. Rep. No. 93-1280, supra note 7, at 372.
90. See note 26 supra.
92. See text accompanying note 84 supra.
for purposes of any of these provisions, although the absence of relevant final or proposed regulations makes this conclusion uncertain.

9. **Reportable Event**—A plan merger is a reportable event requiring notice to the PBGC under section 4043, unless both plans involved in the merger come within the section 4021(b) exemptions.93

C. **Liquidating an H.R. 10 Plan**

A final, although poor, alternative for disposing of an H.R. 10 plan in connection with incorporation of a proprietorship or partnership is to liquidate the plan. Since H.R. 10 participants will continue working at the same jobs after incorporation of the unincorporated business, amounts received by them in connection with the H.R. 10 plan liquidation will not qualify as amounts received on account of "separation from the service" of the unincorporated employer.94 These amounts, therefore, will be ineligible for favorable lump-sum treatment or rollover into an Individual Retirement Account or corporate qualified plan95 unless the employee is older than 59 1/296 or is a five year participant covered by Public Law 94-267. Furthermore, liquidation amounts received by owner-employees under age 59 1/2 will be premature distributions subject to a penalty tax97 unless the distribution is (1) in the form of a non-transferable deferred annuity paying no benefits before death, disability, or attainment of age 59 1/2 or (2) in the form of nontransferable, deferred maturity United States Government retirement bonds.98 Owner-employees under age 59 1/2, therefore, cannot receive any present liquid benefit from an H.R. 10 plan liquidation without incurring the premature distribution penalty tax. For the stubborn few who are willing to cope with the above problems in order to liquidate an H.R. 10 plan, additional considerations are applicable.

1. **ERISA Termination and Insurance Provisions**—Liquidation of an H.R. 10 plan would clearly involve a "termination" for purposes of

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96. Danker, supra note 5, at 715. Note, however, the Internal Revenue Service's contention that only profit-sharing plans can pay pre-retirement benefits to those who have attained age 59 1/2 but are still in service. TIR 1403, M-15. See Treas. Reg. § 1.401-12(m)(2) (1960).
97. INT. REV. CODE OF 1954, § 72(m)(5).
the ERISA termination procedures described above. Therefore, unless the plan comes within one of the section 4021(b) exemptions, prior notice of the liquidation must be given to the PBGC, the liquidation distribution cannot occur until receipt of PBGC approval, and the liquidation may result in section 4062(b) liability to the PBGC. Also, under sections 403(d)(1) and 4044(a) of ERISA, the rigid allocation priorities will apply to the liquidation of an H.R. 10 plan, regardless of whether it comes within the section 4021(b) exemptions.

2. Full Vesting Requirement—Participants in the rare H.R. 10 plan that provides less than immediate vesting would be entitled to full vesting on liquidation of the plan.101

3. Prohibited Transactions Rules—Since distributions of plan benefits to those entitled to receive them are excluded from the ERISA prohibited transactions rules, a plan liquidation would encounter no difficulty on this point.

4. Limitations on Benefits to Highly Compensated Employees—The Treasury Regulation 1.401-4(c) limitations on benefits to highly compensated employees would be applicable to the liquidation of a defined benefit H.R. 10 plan.103

5. Permanency—The permanency rule will be applicable to an H.R. 10 plan liquidation under the same circumstances and to the same extent as in the case of a freeze.104

III. Conclusion

An H.R. 10 plan of a business about to be incorporated may be disposed of by freeze, liquidation, or merger into the corporate plan. As a practical matter, however, a merger will accomplish little more than a freeze in many cases, while exposing the participants to constructive receipt dangers and raising unresolved questions concerning the prohibited transactions rules. If an H.R. 10 plan is liquidated, cash distributions to participants will usually be denied lump-sum treatment and will be subjected to the premature distribution penalty in the case of owner-employees. In most instances, therefore, a freeze is the only practical path for disposing of an H.R. 10 plan where a business is on the verge of incorporation.105

99. PBGC News Release 76-2, § 4041(a)-B, supra note 25, at ¶ 120,030. See also text accompanying note 91 supra.
100. Id. §§ 4041(a)-A, 4062(b)-A.
102. Id. § 4975(d)(9); ERISA §§ 408(b)(9), (c)(1).
103. See text accompanying notes 9-12 supra.
104. See text accompanying notes 35-40 supra.
105. See Panel Discussion, Professional Corporations, 24 Tax Law. 223, 231 (1971); B. Eaton, supra note 40, at 14-159 to -163.