



TAX EXEMPT AND
GOVERNMENT ENTITIES
DIVISION

DEPARTMENT OF THE TREASURY
INTERNAL REVENUE SERVICE
WASHINGTON, D.C. 20224

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Dear Sirs and Madam:

This responds to your letter of December 22, 2004, regarding my memorandum of October 22, 2004, to the Directors of EP Examinations and EP Determinations Redesign regarding certain plan designs and short service employees. Your letter states that you have concerns regarding some language in the memorandum and that you would appreciate clarification of this language.

Specifically, your letter states that you have concerns with the language beginning with the second paragraph on page four of the memorandum that provides, "[i]n the absence of questionable hiring practices, a violation may also occur where the employer uses a plan design to limit benefits to a select group of highly compensated employees and to the lowest paid of the non-highly compensated employees." Your letter further states that you believe this language would render invalid a number of plan designs that have long been considered acceptable by the Service through the issuance of prior determination letters.

The memo of October 22, 2004, focuses primarily on plan designs which are intended to satisfy the nondiscrimination tests of section 401(a)(4) only by allocating amounts to the sponsor's lowest paid employees who may have very short periods of service. Generally, we are focused on designs that provide allocations to the lowest paid employees who also happen to be short service employees. It is this combination of characteristics — lowest paid employees with short service — that we believe has the

potential to be abusive. Under this plan design, and as reflected in the two examples in the memo, the amounts allocated to the sponsor's lowest paid employees can be expected to provide minimal actual benefits to these employees.

The language you quote from the memo was not intended to set forth a separate rule where short service employees are not an issue. Instead, the language was intended to indicate that questionable hiring practices are not a required element to a finding of discrimination. As the memo's discussion and examples demonstrate, the intent of the October 22, 2004 memorandum is to focus upon plans that attempt to satisfy the nondiscrimination tests by using nominal contributions or benefits for the lowest paid non-highly compensated employees where the nominal contributions or benefits result from very short periods of service. We believe that attempts to satisfy the nondiscrimination tests should and will fail where virtually all of the plan contributions or benefits, except for nominal contributions or benefits for these lowest-paid employees, are accrued by the highly compensated employees. The memo should be construed in light of this intent. We understand that some may question whether we are reversing positions on certain plan designs that the Service may previously have looked at favorably. However, the memorandum of October 22, 2004, is not intended to suggest that plan designs that have been consistently and repeatedly approved by the Service are now in question. That memorandum is also not intended to address any possible concerns raised by this plan design under section 401(a)(26).

I hope this letter resolves any questions you may have regarding our memorandum of October 22, 2004.

Sincerely,

/s/

Carol D. Gold
Director, Employee Plans